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INVESTMENT TRUSTS AND INVESTMENT COMPANIES

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BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON BANKING AND CURRENCY UNITED STATES SENATE

SEVENTY-SIXTH CONGRESS

THIRD SESSION

ON

S. 3580

A BILL TO PROVIDE FOR THE REGISTRATION AND REGULATION OF INVESTMENT COMPANIES AND INVESTMENT ADVISERS, AND FOR OTHER PURPOSES

PART 2

APRIL 12, 15, 16, 17, 18, 19, 22, 23, 24, 25 and 26, 1940

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INVESTMENT TRUSTS AND INVESTMENT COMPANIES

FRIDAY, APRIL 12, 1940

United States Senate,
Subcommittee on Securities and Exchange of
the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on Wednesday, April 10, 1940, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, Downey, Frazier, and Taft.

Senator Wagner. The subcommittee will come to order. Mr. Arthur Bunker, of the Lehman Corporation, New York City, is the first witness, I believe.

Mr. Bunker, would you rather make your statement without interruption and then yield to questions?

Mr. Bunker. I will be very glad to have questions as I go along with my statement.

Senator Wagner. All right.

Mr. Bunker. Shall I proceed?

Senator Wagner. Yes.

STATEMENT OF ARTHUR H. BUNKER, EXECUTIVE VICE PRESIDENT, THE LEHMAN CORPORATION, NEW YORK CITY

Mr. Bunker. To identify myself, my name is Arthur H. Bunker. I am executive vice president of the Lehman Corporation, one of the largest closed-end investment companies——

Senator Wagner (interposing). Will you please keep your voice up a little?

Mr. Bunker. Keep my voice up a little?

Senator Wagner. Yes; so everybody round the table can hear you.

Mr. Bunker. I am executive vice president of the Lehman Corporation, one of the largest closed-end investment companies, having assets of about $70,000,000 at the present time.

While my company was sponsored by an investment banking house, I have never been affiliated with that banking house and I am, and always have been, therefore, an independent officer and member of the board of my company.

The views which I shall express are those of myself and those of my company, and in an informal way, I believe, represent the views also of a committee of closed-end investment companies, of which I am chairman, a group that was formed a number of years ago. This group, as I say, was formed several years ago, at the request of the S. E. C. for the purpose of conveying in a more compact manner the

general views of our section of the "industry" if it may be so termed. Its character has remained entirely informal throughout.

My experience and my direct interest are confined to the closed-end section of the industry. Frankly, I am unfamiliar with many of the practices of the other sections. The closed-end section, I believe, represents one-half or more of all the capital engaged in the business.

At the outset I want to make it perfectly clear that I am in favor of Federal legislation for the regulation of investment companies. I favor such regulation to the extent necessary, and to the extent that it is possible by legislation, to prevent the recurrence of such abuses as have existed in the past or are likely to recur without such legislation. I am not a new convert to the idea of Federal legislation. I have recognized this necessity for many years.

Over 3 years ago, at the public hearings before the Securities and Exchange Commission, when my corporation was being examined in connection with the investigation of the industry, we proposed regulations which in the light of knowledge then available appeared adequate as a cure for such abuses as were then known to exist. They embraced, in general, a requirement for the most detailed publicity and disclosure, coupled with standard accounting practice. They formed the basis, incidentally, of our reports to our stockholders from that time on. We believe these reports can well be regarded as models of accuracy and clear accountancy. We concluded those recommendations with the hope that the Commission would cooperate with the industry in "developing workable regulations."

Since then, knowledge in the matter has expanded. By virtue of the 4 years' study made by the S. E. C., employing possibly 50 statisticians, lawyers, and accountants and spending possibly well over a million dollars, a mass of data on the subject of investment trusts has been assembled. This study disclosed material which could never otherwise have been available to any private group. I am free to admit that the disclosure of the abuses which have existed in the past among some investment companies, has brought home to me the necessity for a greater measure of regulation than I had originally thought necessary or desirable.

I believe, however, that we should proceed upon the basis that legislation for investment companies should go no further than is necessary to safeguard the interests of investors and that in the very interest of investors it should not interfere with the managerial functions one bit more than is necessary; it should not confiscate valuable existing contract rights of stockholders; and it should not interfere with the freedom of choice of the investor, except to that extent which may be clearly necessary in the public interest.

While it is certainly true that it is impossible to prevent by legislation the possibility of all wrongdoing, it is quite possible by legislation completely to hamstring and shackle the operations of investment companies to such an extent that their usefulness may cease to exist.

Now, gentlemen, we have been listening for the past 2 weeks to a sorry picture. I am sure you will believe me when I tell you that it has been no pleasure for me to sit here day after day and listen to the story of abuses which have existed in an industry of which I am a member.

Needless to say, I do not feel called upon to condone such abuses as the embezzlement of funds of investment companies by criminals any

more than the president of a bank would feel called upon to condone the embezzlement of bank funds just because he happened to be a bank president. Nor would I, or anybody else, think that an honorable bank president had to apologize because some officer of another bank had been guilty of larceny.

In the light of the story which you have heard, it would not be unnatural if there had been aroused in you a burning conviction that regulation of investment companies must be undertaken by the Federal Government, something which none of us denies, and then with these misdeeds in mind you might well fail to give the proposed regulations that careful scrutiny which all legislation requires. These abuses create a powerful impression.

Even Judge Healy, whose obvious desire to be scrupulously fair in the presentation of his case has won my admiration, has nevertheless allowed himself to state to the committee, after parading the picture of these misdeeds, that he believed he had presented "a fairly comprehensive picture of the investment trust industry and its characteristics." I can hardly believe that Judge Healy meant what he said, for the fragments of the industry which you have been shown came from only one side of it—its worst side.

Now, that is all you have heard, so I think I have a right to ask you to consider these abuses in their proper perspective. I think in fairness to the respectable elements of this business—which I can assure you are in the vast majority—and in fairness to the stockholders of this business, I have a right to ask you to examine with care each provision of the bill which is set before you; that you ask yourselves the purpose of each provision and whether it accomplishes this purpose, and whether in so doing it goes beyond the necessities and needlessly interferes with sound management discretion or with existing contract rights of stockholders, or with the freedom of choice which an investor has a right to insist upon except in those cases of overriding public necessity.

I think it would be constructive to review briefly the parade of abuses that the preceding testimony has revealed, and in a calm manner to see what lessons can be learned from them.

In the first place, there have been laid before you some shocking instances of abuse with respect to the selling of securities of investment companies. My experience has been confined to the closed-end field and I am not competent to analyze that testimony. This phase of the matter I am sure will be satisfactorily dealt with at length by representatives of the open-end investment companies. But I do feel that I can adequately review and throw further light upon the character of abuses which have occurred in the closed-end field.

We have listened to a recital of the criminal acts of embezzlers in the case of Continental Securities, and of the looting by thieves in connection with Reynolds Investing and other companies. Some of these people have already been convicted and sentenced. Others, we have been told, escaped through a miscarriage of justice. Even all murderers do not go to the gallows. However, if the law is deficient and further legislation is necessary to facilitate the conviction of criminals—naively described by some witnesses as "amateurs"—let such legislation be enacted.

Now, I do not feel and I do not say that conviction of criminals is a complete answer to the lesson of the *Continental Securities case* and

other cases which I have just heard described. Those cases have shown that the opportunity for criminals to loot those companies was made easier because of the present lack of certain control. Those criminals were permitted by law, as it now stands, to put themselves into a position where they could accomplish their unlawful designs. They were able to obtain control of investment companies overnight without the consent of the stockholders of those companies. I favor such legislation as may be necessary to make such a thing impossible, and I am in general accord with the views expressed by Mr. Fulton on this point in his able presentation to this committee.

Next I come to the case of the Founders group which was so well presented to you by Mr. Carl Stern. This was a very complicated picture. I shall not take your time to analyze it in detail, although if the time and my personal ability permitted, much could be gained by separating the wheat from the chaff. Much could be gained if we were to find out just how much was lost and for what reasons. But I think it is sufficient for our purposes to realize that the investors in this enterprise suffered tremendous losses through malpractice of various sorts. In the first place, the promotional methods by which these companies were organized were highly improper. Much of this I am confident could not be repeated today with the controls imposed by the Securities Act of 1933, and the Securities Exchange Act of 1934. The first act would have required full disclosure to the investor, which we were told was not made, and the second act would have prevented manipulative practices in connection with the sale of these securities. If further legislation is needed to prevent a recurrence of such malpractice, I heartily favor it.

Another abuse which contributed not only to the misleading methods of selling securities but also to improper operation was the pyramiding of one company upon another and the complicated relationships and dealings between these companies. I am opposed to pyramiding. But I do not object to one investment company holding securities of another if it stops there and if there is little or no cross-ownership and no circular ownership. Transactions between companies of such systems as may be permitted to exist in future should, if not completely prohibited, be subject to rigid safeguards. Such provisions would eliminate many of the abuses described to you in the Founders picture.

Now, the prize package in the Founders group seemed to be the Buenos Aires subway. It is my understanding that the testimony showed that the loss on this investment amounted to about 50 percent over a period of time, during which I believe most securities declined substantially in value. I have a feeling that probably not much more money was lost here in this venture than might have been lost if a diversified list of securities had been bought in the open market instead. But that is not to say that I condone the subway transaction if it constituted a dumping into the investment company by persons affiliated with the investment company. I favor an absolute prohibition of such transactions. I favor a prohibition on the sale to any investment company of any securities or other property by persons affiliated with such company; and by that I mean officers, directors, managers, or other controlling persons. Conversely, of course, I favor a like prohibition of sales from an investment company to any such persons. This prohibition would take care of such

cases as the German and French electric companies and many other situations described to you as "dumping."

I am sure you will understand that I would mean this to include a prohibition on loans to officers and directors and any other similar method of effecting a bail-out. But I do not think it is necessary to write a law of 100 pages to prevent the recurrence of these abuses.

Now, I have reviewed very briefly the nature of the testimony that has come before you. I do not think it is necessary at this time to go into these questions in any greater detail, but I hope that I have said enough to convince you not only that I am opposed to the practices that have been described but also that I am prepared to support legislation which will go a long way to prevent their repetition.

For the purpose of clarity, I believe that I should formulate those principles which I have in mind, and which I believe to be as adequate as they are necessary. They are six in number, as follows:

(1) Prohibitions against self-dealing with affiliated persons.

(2) Prohibitions against any substantial change in management or any change in announced investment policy without prior approval of stockholders.

(3) Periodic full publicity covering all activities of a company.

(4) In connection with banker or broker managed companies, a requirement for a fixed percentage of independent directors on the Board.

Senator WAGNER. You say there should be a certain number of independent directors. Have you in mind whether they should represent the majority or minority directors?

Mr. BUNKER. Well, Senator, it depends very much on the other features of the bill. If you should take the bill as it is now written and accept every other section of the bill except that one section, I do not think you need any independent directors. But if you were to leave out a great many other sections of the bill you might need to go up 50 percent. I know that many of these things are interrelated.

Senator WAGNER. You have not formulated in your mind definitely as to whether they should in all cases be a majority of the directorate, but say that that should depend on consequences? How would you describe it?

Mr. BUNKER. I think I would answer it probably in another way. I would say that the purpose of that is to prevent certain things. If I have prevented every other possible thing, if, for example, I have prevented all forms of self-dealings and all forms of bailing out and all forms of other things that have been criticised, and have actually physically stopped all those things, there is not anything that can be done about it. So it depends on what you do. But I would not put layer upon layer.

Senator WAGNER. But you think they should have independent directors?

Mr. BUNKER. Yes; I think it is essentially desirable.

The fifth principle which I have in mind is the use of approved accounting practices coupled with reports audited by independent accountants.

The sixth is the establishment of a form of tax treatment for all investment companies which will permit them to survive.

I would rather not take the whole tax question up just now. It is well understood by the S. E. C. It is not an invention on my part, and I may say that they are quite sympathetic about it; but it seems to me to be a little out of place here.

Senator DOWNEY. May I intervene with a question?

Senator WAGNER. Certainly.

Senator DOWNEY. I do not want to divert you by a long discussion with reference to something that you may cover later, but you have stated that there are six conditions or principles that you believe should govern the new legislation, and that you believe those are sufficient. Could you indicate to me, very briefly, because I am totally unprepared on this situation, to what extent the recommendations of the Commission in the proposed bill go beyond your six provisions? Perhaps you will cover that later on.

Mr. BUNKER. As a matter of fact, Senator, I frankly do not, because it is a very complex subject. You understand, with reference to these six principles, that I might give you one answer that would incorporate all kinds of subsidiary matters. There must be registration, and other sections of the bill might be lifted out and put in here, but the present bill gives you the embodiment of these six principles. I did not happen to treat the matter at all here, because we are going to take up the bill by sections, with numerous other principles some of which I will take up later on. I do not think there is a very simple answer to it, Senator. It is a very complex question.

That, in short, is my position with respect to regulation of this industry. On the other hand, while this limits, it does not dispose of the controversy. There is a wide gap between such views and those which have resulted in the present bill. There is a wider gap between my picture of the industry and that which has been submitted to this committee by the S. E. C. in the past 2 weeks. In judging the matter, it does not seem to me that any solution can be properly arrived at without bringing to light many more extensive and pertinent facts than those which have so far been produced at these hearings. Also it seems to me necessary at this point, in fairness to our industry, to clear up some of the misunderstandings and erroneous impressions which have inadvertently crept into the record of these hearings to date.

In the first place it is a mistake and a very serious mistake to confuse in the slightest degree the conception of investment companies with the conception of savings banks. If a man puts his savings in a savings bank he has money in the bank, money which, subject to minor restrictions, he can withdraw at any time and which he can withdraw in the same amount which he has put in, plus interest, no more and no less. That is his contract.

But if a man invests in the stock of an investment company and particularly if he invests in the common stock of an investment company, he is putting his money at the risk of the market and when he realizes on his investment he will realize the then market value of his investment, which he hopes may be more, but which may very well be less than he has paid in, by the terms of his contract.

If any salesmen of investment company securities have attempted to confuse investment companies with savings banks they have been guilty of gross fraud and they should be dealt with accordingly. If additional legislation is necessary for such purpose let such additional

legislation be passed. But do not allow yourself to be misled, because of fraudulent statements of this nature that have been repeated to you, into the idea that investment companies resemble savings banks. Any inadvertent confusion on this subject on the part of the gentlemen who have preceded me should be erased from your mind.

Again, in referring to the fact that only 650 investment companies now remain out of 1,300 which were created, Judge Healy in his opening statement said:

At present only some 650 or approximately one-half of the investment companies formed in this country are still in existence. The other companies have disappeared through bankruptcy, receivership, dissolution, mergers and consolidations.

The clear implication of this statement to me is that the fate was the same, namely, disastrous, whether the company disappeared on the one hand through bankruptcy or receivership, or on the other through merger or consolidation. Apparently I am not alone in my interpretation of what such a statement conveys. Here is how it seemed to the New York Times on April 3 in reporting this hearing:

Mr. Healy told the subcommittee that in the last 15 years approximately 1,300 investment trust companies had been formed, of whom about half had failed.

It is unfortunate that this impression was conveyed. We all know that many of these 650 companies have consolidated with the larger organizations of other active operating companies.

In the same paragraph of the Commissioner's statement two other remarks have drawn comment in the press. They are:

The American public has contributed over $7,000,000,000 to these organizations. The value of their assets at present is approximately $4,000,000,000.

And then again the statement:

Altogether investors have sustained a capital shrinkage of approximately $3,000,000,000 in all types of investment trusts and investment companies.

Now the meaning of this statement might well be that the $3,000,000,000 figure of losses is a calculated figure representing the difference between the amount of money contributed and the amount of money remaining in the industry. I may be wrong, but my understanding is that these figures are in no way related to each other. As a matter of fact, if the figures are correct with respect to the amount of contributed capital and the amount of remaining assets, that figure given to represent the losses must be completely incorrect and must represent an exaggeration of loss infinitely greater that the true loss which has occurred. The reason for this is best demonstrated by reference to House Document 70, pages 184 and 187, which is the study of the S. E. C., where the following statements appear:

It is, therefore, estimated that the grand total of sales of securities by investment companies of all types from their inception in this country up to the end of 1937 was approximately $7,200,000,000.

During the years 1927 to 1936, investment trusts and investment companies repurchased or redeemed approximately $1,200,000,000 of their own securities, valued on the basis of cost to the trusts and companies. If these repurchases be deducted from the value of sales of investment company issues which represents total moneys contributed by the public to investment companies, then the net public contribution would be approximately $5,300,000,000 during the years 1927 to 1936, and about $6,000,000,000 during the entire existence of these trusts and companies up to the end of 1937.

As the statements indicate, there is of course constantly at work an element of repurchase of securities by companies of their own stock. It is more active in the case of open-end companies, but it operates also in close-end companies. The repurchase of securities by a company is equivalent to the return of capital to stockholders and must be given credit as a deduction from the amount of capital originally contributed by stockholders. It is essential that this credit be given before any losses are calculated. It is my understanding that this has not been done. It is my further understanding that in fact no such sum as this has been lost through shrinkage.

Indeed, this statement of Judge Healy seems to have been particularly confusing. For example, Senator Wagner, in his remarks to the committee on April 8 obviously had understood it to mean that $3,000,000 had not only been lost but that a large part of it had been looted. His understanding was, of course, perfectly logical. However, since it has been necessary for me to familiarize myself with the extensive studies of the S. E. C. and the statistical facts contained therein, I know that such an interpretation does not reflect the true situation, and that any such interpretation is absolutely and completely erroneous. And I am sure that Judge Healy would be the first to agree with me.

Senator DOWNEY. Are you leaving the subject, now, as to the amount of shrinkage which occurred in the assets of the company?

Mr. BUNKER. Yes, Senator.

Senator DOWNEY. I want to intervene to ask you this question. I have heard very little of the testimony. Was there any testimony on the part of the Commission showing how much of this remaining shrinkage of two or three billions, whatever it was, had occurred through the general shrinkage in values in the Nation over this decade?

Mr. BUNKER. No, Senator; in the testimony to which I have referred there was none. It is perfectly obvious from a study of all of the data that the greater percentage was the same shrinkage in value that occurred in every walk of life over the period 1929 to 1935 or 1937.

Senator DOWNEY. If I may make this comment at this time: As long as it is considered an important issue in this matter, I would like to have some idea in my own mind on this particular phase of the inquiry. If there was a shrinkage of $3,000,000,000, or a looting of that amount, or of a smaller amount, as Mr. Bunker suggests, I would like to have somebody apprise me as to how much of the shrinkage or loss occurred in what you might term legitimate ways; that is, through the general depression of the values of securities and property in America over the period from 1930 to 1936 or 1937. I do not want to interrupt Mr. Bunker for that purpose.

Senator WAGNER. There are references in the testimony, as I recall, that part of it was due to shrinkage, or, as you say, was due to maladministration. But I think there should be a definite separation.

Mr. BUNKER. Oh, yes.

Senator WAGNER. I do not think you could minimize the testimony here which had to do with a large part of the assets of particular companies. I know that in your testimony you deplore the abuses which have occurred. Let us say that the money was lost through maladministration; perhaps looting is too strong a term in some instances. But a great deal of that money was lost, was it not, by particular companies whose experience has been presented here?

Mr. BUNKER. Senator, it is the most extraordinarily difficult problem in the world to find out. I have been over it. If you read the case of Company A, involving 400 pages, and then read the case of Company B you will find the whole story told all over again. It may be necessary to do that, but it is difficult to distinguish how much money has been lost because of the failure of honest judgment. For example, because 100 shares of General Motors stock, which was once quoted at $100, and is now quoted at $50, were invested in and you lost 50 percent of your money, it is difficult to tell how much was because of manipulative practices and how much was because of the decline in prices of securities. I do not condone what has been stolen or lost in all these practices.

Senator TAFT. I do not see how anybody can determine the figures. I suppose a study could be made showing what money invested in stocks on the New York Stock Exchange at the times at which it was invested, would have produced if let alone. That could be done. I do not see any other basis for guessing.

Senator DOWNEY. I do not think that would quite answer the question, because if the investment was made in 1929 and was then cashed out in 1933 you could not hold the company to the value that might exist in 1937 or 1939.

I am not at all expressing my opinion and I am certainly not attempting to minimize the effect of the case of the Commission. I do not mean that. But I do want to say this, that certainly my attitude upon the question of regimentation and control that might be necessary over these trusts would be very much affected by the answer to this question. Suppose we did start with an investment of $7,000,000,000. If $3,000,000,000 of that amount was lost through improper administration and looting, that is one situation. If $2,000,000,000 or $2,500,000,000 came about through depreciation of values, or maybe there was only a loss of two or three hundred millions, through maladministration, that is a very different situation. I must admit that I would like to have a clearer idea on this. Of course there was a tremendous shrinkage in values, as we all know who were in business life at all.

Senator WAGNER. It is appreciated that that is a very important factor. We have heard the instance of Founders and of Continental Securities, and a number of others whose assets were somewhat smaller where there have been definite abuses. Some of those who have been found guilty thereof have gone to jail. But large sums of money have been lost. Many of these instances, or a number of them, occurred during periods after 1929. Founders began with $500,000,000 and ended with $48,000,000. There were practices that I do not think any members of the industry would defend. They resulted in large losses in the experience of that particular company. Five hundred million dollars is a lot of money for small investors to invest and lose. We had a recitation of the practices, which certainly I condemn, and I am sure that everybody else does. Mr. Bunker has condemned it. If we can prevent that sort of thing in the future by any kind of regulation, if we can prevent a practice of that kind from recurring and causing loss to people who have invested their money, I think we ought to do it. That is the position that I am taking.

Senator DOWNEY. I am not in any way condoning mismanagement, but I think I would approach this problem from an entirely different

viewpoint if the losses through mismanagement were only 5 or 10 percent, or they were 25 or 50 or 60 percent. I must admit that I was left somewhat with the idea that it was the contention of the Commission that there had been a loss of several billions through looting and mismanagement. I was left with that impression. If that is not correct—I know that Judge Healy undoubtedly stated only the facts, and if I have made an erroneous interpretation, that is my own fault—I would like to know the facts.

Senator WAGNER. I will ask Mr. Bunker this question. Perhaps you can give us an estimate. You listened to the testimony of the experience of Continental Securities Co. How much of that loss, which was almost a complete loss, about $15,000,000, do you say was due to dishonesty or maladministration?

Mr. BUNKER. In my opinion, I think that all of the money lost in the Continental chain was lost through malpractice from the date that those fellows first got into control. I think they lost seven or eight million dollars. I know the testimony said $15,000,000, but I happen to think that that is wrong.

Senator WAGNER. Supposing it is $7,000,000: That is a lot of money.

Mr. BUNKER. Yes. Every cent that was lost by those criminals and embezzlers was lost because of that fact. But in the Founders situation I cannot tell you; but I suppose that not 10 percent of the shrinkage in value was due to any criminal act of embezzlement. My guess would be that it was mismanagement. Five hundred million dollars, if not normally managed, over that same period of time would probably have shrunk to $100,000,000 or $150,000,000.

They have got 400 pages on Founders, and that statement appears and reappears. But it is not because they stole all of that money. They did shocking things and they stole plenty; but there is a tremendous difference between them. I would not be caught defending Founders for anything, Senator.

Senator WAGNER. I know that.

Mr. BUNKER. So don't misunderstand me.

Senator WAGNER. But even on your own estimate it would be about $100,000,000 loss. Let us not minimize that $100,000,000.

Senator DOWNEY. If you show an investment of $7,000,000,000, and then show looting, which occurs even in national banks, involving 1 or 2 percent, and then a general loss of $3,000,000,000 which may occur through the general collapse in the Nation, it is unfair to argue that because in one particular company or 5 or 10 particular companies you have shown losses through embezzling, no claim should be made by which you would be led to the confused belief that your over-all losses occurred through that. I think that ought to be made very clear.

Senator WAGNER. I am not interested in whether it was less than $3,000,000,000 or not, as much as I am in this; that if we can, by any kind of regulation, we should prevent the recurring of looting. I think we should do so. Mr. Bunker thinks that probably$100,000,000 of loss in the case of Founders was the result of dishonesty.

Mr. BUNKER. I do not know. It is a most difficult proposition.

Senator WAGNER. I do not minimize that. That represents investments all over this country. If we can prevent that by regulation of some kind, I am sure that the industry is going to be for that.

Mr. Bunker has practically said so already in his testimony. We should prevent that sort of looting and dishonest practices which deprive people of their hard-earned money. It is our duty to do it.

Senator TAFT. But Senator Downey raises the question——

Senator WAGNER. Wait a moment. I have not finished. So in the case of the Continental. I cannot minimize these losses which have been the result of absolute looting and dishonesty. Men in that particular case have gone to jail and are there now. Of course we have got to be deliberate about this matter and not pass any kind of regulation which in any way impedes or interferes with the proper operation of the existing trusts that are decently run. I do not think it matters much whether the loss was $1,000,000,000 or $1,500,000,000 or $2,000,000,000. The question is: Can we prevent those things occurring in the future so that people will not lose their investment?

Senator TAFT. But there is a logical question as to whether you are going to regulate the trusts by trying to prevent dishonesty, which you can do in a very much simpler method than by anything provided for in this bill, or whether they are really shot through with such complete false bases, resulting in inevitable losses, that we need a bill like this which regulates practically every action of every officer of every investment trust in the United States.

Senator WAGNER. That is what the committee will have to decide when we get through with the testimony.

Senator TAFT. So I think that Senator Downey's request for information as to whether this is something that really convicts the whole industry, or whether it is confined to isolated cases of dishonesty which can easily be dealt with directly, is a material question. I think we would like to have as much information as we can get.

Senator WAGNER. Of course. That is why we are having the hearings. But I think there is a good deal in this proposed legislation of which the industry itself approves. I just cannot in my mind minimize these losses that the public has suffered as a result of this looting, which I think can be prevented by legislation. This may not be the right way. We may have to change provisions of the bill. Of course bills are always not only written but rewritten. I want to approach the subject absolutely impartially and simply to pass such legislation as everyone concedes is needed—some form of regulation—to prevent these abuses in the future. It is our duty as members of this committee to listen carefully to both sides and listen to all the facts, and then we will develop legislation which is needed to prevent these abuses in the future. That is all I am interested in. Whether the amount is two billions or one billion is not so important with me. Of course that is a lot of money.

Senator DOWNEY. I would like, Mr. Chairman, to make myself still clearer. I am one of the very strong admirers of the Securities and Exchange Commission and of their personnel. I think they have done a great work. On the other hand, I am very anxious in this hearing as in all other hearings to see that we have a clear, fair, and equitable understanding of the issues. I cannot agree with you in this respect. If on a $7,000,000,000 investment there was a loss, say, of 5 or 10 percent, say $350,000,000 or $700,000,000, through looting and mismanagement, I cannot agree that our approach to the problem would be the same as if there were a loss of 25 or 50 percent through looting and

mismanagement. Unfortunately, we have certain weaknesses in human nature. Embezzlement occurs; mismanagement occurs; looting occurs; and whether the result of such mismanagement or looting covers 1 percent or 10 percent or 25 percent or 50 percent is, I think, very important in determining the general character of the control that we are willing to place over them. I want the very best law that can be worked out. I am sympathetic to this kind of a law, not antagonistic to it. But I do want to know the facts, whether the losses due to mismanagement and looting covered 5 percent, 10 percent, 25 percent or 50 percent of the investment.

Senator WAGNER. There has been some testimony given on that point. There may be additional testimony that members of the committee will want and to which they are entitled and which they will undoubtedly get. I do not want to be misunderstood here. I will say this, that whether it is 10 percent or 5 percent, if the looting can be prevented by regulation which in no way interferes with the legitimate operation of the industry itself, it is our duty to pass such regulation.

Senator TAFT. I agree a hundred percent. I think we all agree.

Senator WAGNER. That is all I am saying.

Senator DOWNEY. I think you are stating the obvious. But, Mr. Chairman, let me go further. I think it would be grossly unfair to allow information to go out from this committee under which the public would believe that there had been far greater losses than there were, through looting and mismanagement. I say that not only for the sake of fairness, but I would like to see this particular issue clarified.

Senator WAGNER. I agree with you there. We are all agreed on that, too.

Senator HERRING. May I suggest that we hear the witness a little while, and make our arguments later.

Senator FRAZIER. I would like to ask the witness if he cares to make an estimate of what percentage of this shrinkage of $3,000,000,000 was because of looting and mismanagement.

Mr. BUNKER. If you will take it just as a mental guess, or as one man to another——

Senator FRAZIER. You are in position to know the situation. You have heard the testimony here and you know a good deal about it. I would like to have your opinion about it.

Mr. BUNKER. A maximum of 10 percent. I would go further. I would say that I do not believe, in the last 7 or 8 years, that the total money lost from looting in this business has been 1 percent of the assets of the entire aggregation of capital. That is a guess. I cannot do the statistical work. I have not all the data.

I was just coming to the point of impressions. The presentation of the case against the investment trust industry by the S. E. C. must have left an impression upon you that is necessarily distorted. You have had only one side of the picture, and that has been highlighted by picked examples of outrageous abuse. In fact you are in a position very similar to that of the man to whom a mining prospector comes with interesting specimens from a mine which he says he has just discovered.

Now, as an old mining man I am accustomed to the problem of investigation of mining properties. It is a somewhat different affair from an investigation of this sort. The first rule in such work is to distinguish between specimens and samples. Specimens are those

selections rich in material that are always completely unrepresentative of the mine as a whole, while samples are those materials taken with great care and intelligence for the purpose of reflecting an accurate picture of the mine as a whole, of what can be expected in the course of more penetrating work. Specimens are easy to select. Samples are of a much more difficult order. Specimens are always misleading; well taken samples provide a basis of reliance.

What you have been listening to for the past 2 weeks, gentlemen, in my opinion is an analysis of a few specimens, and you have not heard anything about the average sampling of the ore. Of course, in a mine the specimens are examples of the best, and in an investigation we all now know that the specimens are examples of the worst. I do not believe that it would be any wiser to write a law based upon specimens than it would be to buy a mine based upon specimens. The latter, I know, is fatal.

Now this business of selecting specimens may be interesting but it is not very instructive. For example, if it fell to my lot to argue the other side of the case, I would produce specimens having as much virtue as the ones you have listened to had vice. To illustrate, it was necessary 3 years ago for my company to report on the state of its affairs before the S. E. C. (I cite this particular example because the S. E. C. is officially in possession of the same data.) It was able to state that for those stockholders who had paid $104 on the date of formation of the company, namely September 25, 1929, there were available for each share of stock on November 7, 1936, assets of a net value of $134.34; and that, further, in the meantime each share had received during that period of 7 years $19.35 in dividends. In other words, over the period of the world's greatest financial disaster, it was possible for my company to render to every original shareholder, for the $104 which he had paid in 1929, an accounting of almost $154 in 1936. The record of this operation is as extraordinarily good as the records of the ones you have listened to were disastrous.

Senator Downey. What range of security companies are you covering?

Mr. Bunker. This is my own company. I am saying that if I had to pick specimens to argue the other side of the case I could find them in numerous companies. Among a few are General American Investors and National Bond and Share. Strangely enough, these which I have mentioned, and which have such excellent records, have been operated under banker-manager sponsorship which you have been informed is one of the most evil relationships that can exist in this industry.

But neither these specimens, on the one hand, nor the other specimens to which you have listened, on the other, are in any sense representative of a true and average story of the industry. They are interesting but they are not very useful in determining what the totality of the situation really is.

I have touched on the evidence that has been presented to you by the S. E. C. and I have told you where I stand on legislation and regulations that would, in my opinion, adequately and effectively cure the malpractice which has been brought to light. Now, before we go on to a discussion of the details of the bill that is before you, I feel that it is essential that I bring to your attention certain im-

portant facts with respect to the constructive side of this industry, which have been thus far overlooked in these hearings. I am sure that you will wish to hear them so that both sides of the picture may be clearly on record.

There are in the studies of the S. E. C. which have been presented to the Congress, thousands of pages of findings and conclusions relating to the general experience and performance of the industry. It is too much to expect that any great number of people should have taken the days or weeks of time which would be required to make a careful study of such voluminous material. My own opinion is derived from not only a minute and careful examination of all of this material as it has been made available to the public, but also from daily operating experience as senior executive officer of one of the largest investment companies, which position I have held from the time this company was founded until the present day, as its senior executive officer.

To begin with, as you have already heard, ours is a very large industry. Its assets are above $4,000,000,000. It is estimated that there are 1,500,000 stockholders of investment companies as against from 10 to 12,000,000 stockholders of all other American industries. There are thus possibly more Americans owning stock in investment trusts than in any other single American industry. Legislation affecting investment trusts will affect the fortunes of these million and a half stockholders. Our companies in their turn hold securities in virtually every important publicly owned American enterprise. Consequently, legislation if destructive of our industry would have direct and indirect effects throughout the American economy. I emphasize these facts to support my belief that the question of regulation of the investment company industry is one of major importance, with wide ramifications.

Next, as to the historical background. On January 1, 1927, the industry was of negligible size. At that time it had received total contributions of capital in the neighborhood of $700,000,000. Ninety percent of the entire growth of the industry took place in the next 3 years. By the close of 1929 the $700,000,000 figure had been increased to approximately $7,000,000,000 In fact, substantially more than $3,000,000,000 was raised for this industry in the single year of 1929 and a good part of this in the several months preceding the stock market collapse of October 1929.

We may wonder that the world was not wiser than to form these companies at such a time. But the very fact that it was not was responsible for many of the problems that developed in the succeeding years.

It is really necessary to reproduce the sentiments of that era in order to understand the problems of this industry in the days of its infancy.

Here are the views of a justly respected financial agency published on September 30, 1929, a date just past the peak of investment trust flotations:

> We have made a careful survey of general economic conditions and find no logical basis for anticipating a prolonged reaction in the stock market. The continued high rate of activity in industry, with excellent earning power in prospect for the leading corporations makes us believe that the present technical recession in the market offers investors an opportunity to acquire selected stocks for long-pull investment purposes.

Obviously, investment companies could not have been founded in such volume at that time unless practically everyone in the United States had agreed with the above opinion. There had to be willing buyers of the issues that were offered in such profusion. Based upon such optimistic psychology, this $7,000,000 industry was born. But no sooner had it been born than it had to meet the gravest problems of all financial history.

From September 1929 to June 1932, the value of American stocks shrank by at least $125,000,000,000, an amount approximately equal to a third of all the wealth ascribed to the United States in 1929. All fields of our economy were affected.

Senator Downey. What year did you say?

Mr. Bunker. From September 1929 to June 1932, the value of American stocks shrank by at least $125,000,000,000, an amount approximately equal to a third of all the wealth ascribed to the United States in 1929.

Senator Herring. Can we not have copies of this statement? If we had copies of it we could follow it along.

(Copies of the statement referred to were distributed to the members of the subcommittee.)

Mr. Bunker. Probably 40 percent of the 1929 wealth vanished. Conservatively speaking, at least one-fifth of American estates were wiped out. I am sure no one here wants any more extended review of this painful period. But nonetheless, it must be borne in mind that this was the period of the infancy of this industry.

During the depression, the dramatic shrinkage of value of all securities in the United States naturally included those held by investment companies.

When the blow struck, this industry was just passing through the promotional and inflationary stage which seems to be characteristic of the period of birth of any dynamic new American enterprise.

The founders of this industry had not anticipated the most devastating and precipitous collapse in the history of world markets. Many, if not most of the investment trusts that were formed at this period were founded upon the expectation of being able to make large and legitimate profits from investments in special situations, from participation in private ventures, undertaking new ventures, underwriting, etc. It was everyone's hope and belief that the large profit possibilities of the late 1920's would continue indefinitely, and it was the purpose of the organizers and managers of the majority of investment trusts at that time to take advantage of these opportunities rather than to engage solely or primarily in the everyday routine of the management of diversified portfolios. The last thing in the world that they were prepared to do was to establish a defensive investment position and maintain it for the next 3 years, although this definitely was what the times required. Men give up their hopes reluctantly. Here they needed to trade hope for despair and do it quickly.

Certainly, an objective study of any industry's operations during this period should have taken into account primarily the abnormal setting in which the operations had taken place. The S. E. C.'s study does not seem to me to have taken this background into consideration.

But, the S. E. C. did undertake to measure the performance of our industry. It certainly did not do so by reviewing the general situation and establishing our appropriate place in the economic setting of the times. The conclusions at which it arrived are, in my opinion, unrealistic and give no true picture whatever of the actual comparative performance achieved. I am referring of course to the voluminous statistical study prepared by the S. E. C.

This study has suggested again and again that the result the managements of investment companies achieved was exactly nothing, that one would have done just as well had he bought a package of securities as represented in well known indexes and carried them throughout this trying period. In most instances the tests of performance have been measured against the alleged behavior of 90 stocks which composed one of the index averages maintained by the Standard Statistics Co. The S. E. C. statisticians found that the performance of such a theoretical fund and the actual performance of the portfolios of the investment companies were approximately the same, and they conclude that the investor would have done as well to buy such a group of stocks and to avoid all the bother and expense of management. And he would have done even better to buy only Government bonds.

We have examined with care these studies of performance. We knew, of course, that the Standard Statistics Index was primarily a mathematical concept. It never pretended to be a recommendation for an investment fund or to parallel in any sense the operation of an investment fund. On the other hand, the S. E. C. statisticians used this as a basis of measurement, apparently because it was their understanding, as far as one can gather from the voluminous studies, that one could have invested in the group of stocks that composed the index, and remaining so invested over a given period of years, would have had to make only nine changes, occasioned by eliminations and substitutions.

The facts are extraordinarily different. In the first instance, the fund would have had to have the ability to make retroactive changes in its portfolio. But that matter is of only minor moment. We have tried to create such a fund on paper and trace through its theoretical existence in order to see what practical problems might have been encountered. We have been able to work out three methods of handling an actual fund to effect transactions in a fashion somewhat parallel to those effected by the index. In the simplest case, it was necessary to make 333 investment changes in 14 years, but in this case one must have had available at all times an uninvested fund with which to take up the issue of new stock offerings. The behavior of such a fund composed of cash and securities would in no sense have parallelled the index, because of the amounts of uninvested cash.

In another case, it would have been necessary to sell portions of 90 of the securities every time one of the 90 companies offered an issue of new stock. While the result of such a process would have come out exactly the same as the index, it would have occasioned over the period a minimum number of 29,970 transactions. This clearly ruled out this type of operation as wholly impracticable and completely outside of the category described by the S. E. C. as an "unmanaged" fund.

There seemed to be only one method left which was in any way fair and reasonable. This was to have invested a fund in all of the stocks

included in the index in the same proportion in which they were originally represented. And then, upon each of the 333 occasions on which it was necessary to take up rights to purchase stock as offered, to sell that percentage of the rights which would produce cash to purchase the remainder. This would have occasioned innumerable transactions also, but at least would not have required an inexhaustible supply of money. But the interesting thing is that if one had conscientiously pursued such a course, which seems the only one possible, the behavior of the fund so treated would have fallen behind the behavior of the index by over 18 percent for the period from 1927 through 1937. But the assets of the investment companies did not fall behind this index. They exceeded the behavior of such a fund as I have described by over 20 percent—and 20 percent when one is talking in billions is a large sum of money. I realize that this is complicated but, at least in our opinion, it invalidates the statistical premises used by the S. E. C. in assaying the performance records of the investment company industry. In fairness to the S. E. C. I should like to file herewith an extensive study which we have prepared on this subject.

Senator WAGNER. It will be placed in the record at the end of your testimony.

Mr. BUNKER. Now it is true that the S. E. C. has suggested that this comparison is not the only possible one, but it is nonetheless the only one that has been made; further, the S. E. C. has taken no steps whatever and made no effort to throw any more light upon this almost controlling subject. We believe it is appropriate to do so, since it is so very important to view this entire business in some realistic setting. In my opinion, it is essential to analyze the behavior of comparable and related situations which tend to show much better whether the performance has been good or bad. I have prepared a number of these comparisons which I hope will be interesting to the members of this committee. I can assure you, gentlemen, they are not specimens. I do think they will surprise you.

On page 195 of House Document No. 70 there appears a table which furnishes information with respect to the years in which securities of various types of investment companies were issued to the public. It is significant that in this table—representing over $4 billion—approximately $2.7 billion of investment company securities were issued in the year 1929 alone, or, in other words, 65 percent of this large cross section of such issues was sold in 1 single year out of the 9-year period which is incorporated in the table. In other words, 1929 stands out as the year of maximum importance in the formation and issue of investment company securities. Since such was the case, it seemed to be particularly fitting to make a study of all issues, other than investment companies, which were offered and sold in the year 1929 and to trace through their behavior in comparison with the behavior of the portfolios of investment companies.

So far as we have been able, we have therefore made a very careful study of the issues sold in 1929 of industrial, utility, and rail securities—grouping separately common stocks, preferred stocks, and bonds. I should like to submit this study to support the statements I am about to make.

Now the results of this are extremely interesting. The study was large and representative, and traced the 6-year history of over $5.5 billion of 1929 issues. It was inclusive and played no favorites.

The performance of investment companies, according to the study of the S. E. C., was that from the end of 1929 to the end of 1935 they preserved 69 percent of their assets. It was necessary for us to make an adjustment in this figure because the comparison had to be made with the average date of issue in 1929 rather than with the year end. The result of the adjustment established that 56 percent of the assets of investment company portfolios was preserved over the period of this comparative study. It is quite striking, therefore, to discover that compared with such a performance the aggregate value of all other common stocks issued in 1929 was only 33 percent of their issue price at the end of 1935. In other words, investment company portfolios maintained a performance over this period about 60 percent better than these common stocks issued in 1929. Those common stock issues, I might add, included securities of many of the leading industrial companies in the country.

Now as to the behavior of preferred stocks. All of those issued in 1929, together, preserved only 47 percent of their value to the year end of 1935. That is, the assets of the investment companies were preserved over the same period almost 20 percent better than if they had consisted entirely of this group of senior securities.

Bonds issued in 1929, as would be expected, did better and preserved 74 percent; but here one must admit the comparison is almost unrelated, because never at any time was it anticipated by investment trust stockholders that their companies' funds would be substantially invested in high-grade bonds.

All of these 1929 security issues together—common stocks, preferred stocks, and bonds—preserved only 49 percent of their issue value to the end of 1935. In other words, the investment companies preserved 10 percent more of their assets than the average of all these other securities. This seems a much fairer and more realistic test than any which has been applied by the S. E. C. It does look as if management deserves a kind word from someone.

Another statistical comparison seems particularly appropriate. One of the best known investment rating services has for many years rightly enjoyed the reputation of a conservative investment counsel to institutional and individual investors. Its ratings of bonds are officially recognized by governmental agencies. It is fair to say that the recommendations of this established agency may be regarded at any given time as representative of sound and experienced judgment at that time. On September 30, 1929, this organization submitted to its clients a list of about 50 stocks with a recommendation of their purchase for investment. Of these stocks, 37 were given specific ratings—half of them a rating of A or better (Aa in stocks corresponding to Aaa in bonds). We have taken the list of rated stocks, and to give full emphasis to investment standing, we have weighted the list in accordance with the rating, giving A issues a triple weight, the Baa and Ba a double weight, and everything below a single weight.

We believe that the performance of this sophisticated list of rated stocks, weighted as above, and with adjustments for rights and capital changes, is fairly representative of the performance of a first-class "unmanaged" portfolio.

This portfolio, recommended in 1929, had at the end of 1935 a value of 47.9 percent of its 1929 year-end value. Against this figure, the

average of investment trust portfolio valuations at the end of 1935, as we have said, was 69 percent. In other words, investment company portfolios preserved 44 percent more of their assets than if they had been composed entirely of these recommended and leading stocks. Again it would seem that management gave a fair account of itself.

Now, I have not meant to suggest that the investment policy of this highly rated service was ever to buy such stocks and hold them for 6 years, nor could it be sound investment management for anyone to ignore changes in conditions, particularly as they occurred with such overwhelming force at that time. But the point is that the difference between that kind of inaction and actual performance must go to the credit of management of this young industry. And 44 percent is quite a lot of credit.

If we have labored the foregoing facts, our purpose was definitely to lift the investment trust problem out of the unreal setting in which the S. E. C. chose to consider it, and to place it in its proper perspective to the financial happenings of the actual world. Otherwise it would be impossible to view the problem with any clarity and to distinguish from those elements characteristic of the times those which were solely peculiar to the industry. Up to this point they have all been lumped together.

If I had been asked to guess what the performance results of all of these investment companies collectively had been throughout the period of great disaster between 1929 and 1935, I am sure that, bearing in mind that these companies were in their infancy when the great collapse came, I should have guessed a figure far below the performance which was realized, far below the average of other issues of going concerns brought out at the same time, and far below the highly recommended list of investment stocks. Certainly I never should have dared to guess that these new organizations would have far exceeded the average of such other situations.

Possibly, I should have had in mind that they were the only financial institutions of which I could think which did not receive the aid and support of the Government in this critical period. Possibly, when I reflected that aid had been rushed from every source to the commercial banks, savings banks, insurance companies, building and loan companies; when I thought of the $4,000,000,000 worth of mortgages, urban and agricultural, which had been taken over by the Government; of the permission to carry securities at conventional quotations; of the direct aid from the R. F. C. by purchase of preferred stocks and notes—I might have believed that these investment companies would have done well to have survived at all, totally without any aid of this sort.

Also, if my knowledge had been derived only from sitting here these past 2 weeks and hearing of the abuses and frauds, I am sure I should have been convinced that little or nothing could possibly have been left. But when one considers all of the facts, the record of these companies over the depression period has been little short of remarkable.

Another important aspect of our industry should be mentioned. The funds of investment companies have been and should be largely invested in equity securities. We want to emphasize the importance to the continuation of American recovery and industrial expansion that lies in this availability for equity investment of the great fund

of capital represented by the investment-trust industry. We believe that the relative importance of this fund at the present time has not been fully appreciated. It seems to us that we have only to take a casual glance at what is happening to available investment funds to see that more and more of them are being precluded from the purchase of dynamic junior securities which, after all, are those securities which provide the money to start new businesses and to expand existing ones. Life-insurance companies, savings banks, legally restricted trust funds of widows and orphans, and added to these in the last few years, various pension funds, Government social-security funds, and so forth—these are growing in size annually, and are largely restricted to investment in the very highest grade bonds. Men of wealth, who previously were by all odds the largest buyers of equity securities, are more and more preoccupied today with the preservation of their fortunes rather than with their augmentation, or with high yields either in dividends or capital appreciation, to say nothing of the fact that pools of personal wealth are diminishing.

Senator Downey. I regret very much that I have to withdraw.

(Senator Downey withdrew from the hearing room.)

Mr. Bunker. This state of affairs is a result of existing tax laws and we cite it only as a fact, without criticism or comment. It seems to us self-evident that the sources from which is to come money for the purchase of equities are contracting. The investment-trust industry remains perhaps the most important organized reservoir of such capital. Our plea, therefore, is that nothing should be done in the name of regulation and control that will immobilize this great dynamic pool of capital or which will impair its ability to invest intelligently in American industry.

We do not subscribe to the theory that, because the history of our investment companies has been not to invest directly to any great extent in new issues, they do not therefore contribute to the supply of money for enterprise. Our economic links are more interwoven than that. Our economy is rapidly changing. We believe rather that these companies receive funds from a large class of people heretofore not given to purchasing equity securities, and that these funds, when used for equity investment, represent an irreplaceable source of the kind of capital most needed in our economy today.

Just one more word about the industry. I am struck with the fact, in perusing the long studies of the S. E. C., that there is no description of or any comment upon the question of organization or personnel of these companies, or any statement about their equipment and machinery for handling investments. My own observations are that in all of the instances with which I am familiar, the last 10 years have been devoted to selecting and training personnel, toward creating a more competent and specialized organization to deal with the many exacting problems that are inherent in this business, problems which in their wide range require not only the ability to make careful analyses of hundreds of special securities and industries, but to deal with and interpret the significance of such large and continuing questions as the purchasing power of agriculture and labor, the supply of money and credit, the changing value of gold and its ensuing implications on the entire commodity price structure, the effects of international affairs, of economic isolation, and of the complete social change from a laissez-faire economy for which most of the old school analysts

and economists were trained. It is my sincere belief that the investment trust management personnel today is of a far better order of ability and competence than it was in 1929.

All of these facts make me feel it proper to raise the question whether the past 10 years should not be regarded as the years of infancy of a new industry and, therefore, whether one has not a duty to look forward to, and plan constructively for, the next decade, rather than continue looking backward.

I have given a general picture of the importance and size and performance of the industry and I have also given our views on the problem of regulation.

I would like, therefore, to come back again for a moment to a general discussion preliminary to the bill.

I happen to think that in order to fashion a bill based upon the real needs for correction, after impartial consideration of all the facts, a high degree of general cooperation between the industry and the Commission must be established. It is my opinion that such a spirit of cooperation has existed on the part of the industry for the past 4 years. The committee which I represent has earnestly desired the chance to cooperate in the development of a bill. You may have obtained a different impression from the remarks of Commissioner Healy in his opening statement, when he expressed disappointment that representatives of the industry's major elements had not accepted the Commission's suggestion of conferences on the bill during the period intervening between the bill's introduction and the beginning of these hearings.

I can assure you that any suggestion that an effective opportunity for cooperation existed after the introduction of the bill is unrealistic. The full time between the introduction of the bill on March 14 and the commencement of hearings on April 2 was required for preparation. I do not mean to say that it would not have been possible to consult with the Commission for 2 or 3 hours but, on the other hand, I am sure no one would suggest that the development of a bill of this length and complexity would possibly be advanced by such a type of discussion.

My group is not only willing, but anxious, to cooperate; anxious to develop a bill dedicated to the principles which I have announced and to the general principle that we favor regulation adequate to prevent the gross forms of abuse which have occurred and which are not prevented by existing statutes. After all, the section of the industry which I represent has suffered for 4 years under the cloud of these investigations, and under discriminatory and unfair tax treatment, and it is anxious to bring the matter to a close. It will subscribe to any plan of good workmanship and genuine cooperation.

It is for that reason we have been so anxious to come before this body with the hope that after hearing all sides of the case, your committee will lay down principles and instructions as a basis for further developing a proper bill. The present bill, in our opinion, is neither livable nor workable as now written. We believe that it goes far beyond the necessities of the case and that, if it became law in substantially its present form, it might operate to cause the retirement from the industry of desirable elements in it, whose records have been more than creditable and those who have shown scrupulous regard for the interests of stockholders. We do not believe this destructive

result is desired by the authors of the bill or by this committee and we cannot believe that the public good would be furthered thereby.

I have hoped only to set the stage for a fair discussion of the legislation in detail which is proposed. Mr. Quinn, who is to follow me, will take up this legislation in detail and will explain to you gentlemen with more precision the parts which we feel necessary and desirable and the parts which we feel have no proper place in the bill.

With the permission which you have kindly granted, it is my hope to reappear later to discuss certain sections of the bill in detail.

Senator WAGNER. You have not any amendments to the legislation to offer now? You are not prepared to offer any amendments just now?

Mr. BUNKER. No; I am not, Senator.

Senator HUGHES. Will you later—or perhaps this is beside the purpose of this hearing—have anything to say about the tax treatment that you referred to here?

Mr. BUNKER. Oh, I think other people will treat with it. It is a long, complicated situation. I think other people had better deal with it, Senator.

I say that these companies do need special tax preference, and a section of the industry has had it for 4 years. The section of the industry that I represent has not had it. It has been recognized by the House, by the Senate, by the Treasury Department, and so on; and they have enjoyed it for years.

Because, Senator, if this is to be the small man's pool for investments, he has got to be treated at least as well as if he did the same thing for his own account. Right now he is not; right now he is taxed three or four times as much.

Senator WAGNER. You recognize that constructive criticism would include the suggestion of changes in the pending legislation. I take it that if you are not going to do that, someone else representing the industry will propose changes?

Or are you satisfied—and I am sure you are not—with mere criticism, without making suggestions?

Senator HERRING. Mr. Quinn will do that, will he not?

Mr. BUNKER. Yes. The Senator has asked me really a new question. I think you can say that will be covered by Mr. Quinn.

Senator WAGNER. Yes.

Mr. BUNKER. And it will be a detailed discussion. Our idea is not to be destructive in the matter, but to be constructive in the matter. You do happen to have a very complicated situation.

Senator WAGNER. Yes.

Mr. BUNKER. I am sure he will do that.

Senator WAGNER. But the committee would like to have the benefit of definite suggestions as to proposed changes in the bill.

Mr. BUNKER. Well, I think those will derive from our comment, Senator.

Senator WAGNER. Yes.

Mr. BUNKER. I think much more work is needed, but I think it will derive from our comments.

Senator WAGNER. I just want to refer to a few of these practices, and I wondered how you felt about them. Take, for instance, management fees: Is it frequently the case that the contract of employment, or whatever it may be called, is made by the same people

on both sides, in a case that involves, for instance, the investment trust and the bank that receives a management fee or whatever you might call them?

Mr. BUNKER. No.

Is there a dual relationship in a banker-broker-manager relationship? Is that what you have in mind?

There is, in many instances; yes.

Senator WAGNER. I have this in mind—to make it very specific: Here is an investment trust with a board of directors——

Mr. BUNKER. Yes.

Senator WAGNER. And then there is a contract had with any kind of a bank, with a board of directors; then if the majority of the directors of the investment trust are the same persons as the majority of the directors of the bank——

Mr. BUNKER. Yes.

Senator WAGNER (resuming). And there is a management contract, you have a certain specific sum to be paid for management.

Mr. BUNKER. Yes.

Senator WAGNER. If the directors in both cases are the majority, are you not in that case making a contract with yourself?

Mr. BUNKER. We say that whenever you are affiliated, you cannot do any business, anyway. I say, "as affiliated people."

When you say the majority of this company would be the majority of that company, the whole bunch would be affiliated; and I say, "No; you cannot do it."

Senator WAGNER. Very well; and you feel that if it can now be done, it ought to be prevented in the future?

Mr. BUNKER. Absolutely. I have come out most strenously on this.

Senator WAGNER. I know you have, Mr. Bunker. I am trying to get confirmation from you.

Mr. BUNKER. Yes. In that particular picture I say nobody can do business. They are all affiliated people.

Senator WAGNER. Yes.

You have heard testimony about this dilution of assets?

Mr. BUNKER. Yes.

Senator WAGNER. What do you think about that?

Mr. BUNKER. To be perfectly frank, I do not know anything about it, Senator. It is in the open-end section of the business. I have never been in it. I do not understand that business; and I am sure they are competent to deal with that.

Senator WAGNER. In spite of all that has been said here, I do not think you are opposed to as many of the provisions here as one would imagine by the questions and answers that have been given here.

Mr. BUNKER. Yes.

Senator WAGNER. There is another thing I should like to mention at this time: There has been discussion here about the loading charges, and you have heard testimony to the effect that in some cases these loading charges have been as high as 18 or 20 percent.

Mr. BUNKER. Yes.

Senator WAGNER. You certainly do not approve of that kind of practice, do you?

Mr. BUNKER. It is not in my field; but I do not approve of 20 percent loading charges or anything like that.

Senator WAGNER. Of course.

Mr. BUNKER. I mean that I do not, as a citizen, approve of 20 percent loading charges.

Senator WAGNER. I also heard you say that if there is to be a change made in the fundamental policies——

Mr. BUNKER. I am opposed to it, unless the stockholders approve it.

Senator WAGNER. You say that such a fundamental change in policies ought not be made unless the stockholders approve it?

Mr. BUNKER. I say you should not change your fundamental policy unless the stockholders approve it.

Senator WAGNER. Yes.

Mr. BUNKER. That is right.

Senator HUGHES. Mr. Bunker, that presents to me some difficulties. I thought about that as you were testifying; and it seems to me that in those circumstances you would have the difficulty of writing to your stockholders, in a matter of that sort, where it runs into thousands and thousands or into a million or more.

Mr. BUNKER. You refer to the number of stockholders?

Senator HUGHES. Yes.

Mr. BUNKER. Oh, they run up into fifty or sixty thousand, depend-upon the company.

We do not have a very big list; we have between ten and fifteen thousand.

Senator HUGHES. I understand you can send out circulars and what-not.

Mr. BUNKER. Yes, and as we call the usual stockholders' meeting.

Senator HUGHES. A "usual meeting"?

Mr. BUNKER. I say "usual"; I mean we call a special meeting or whatever it is. I think there is a difficulty in determining what is fundamental policy. I think that policy takes workmanship. I am just as sympathetic; but I do not think you should change it without approval. It takes workmanship, and I do not think you should change it unless you get the approval; you should not decide on a change, without the approval of all the stockholders. That is my position.

Senator WAGNER. You remember some of the advertisements that have appeared in the papers with reference to some of these proposed investments, giving the impression that it was an investment trust with diversified investments in its portfolio and giving the impression that it was one of those which was not engaged in any new ventures or risks or anything of that kind?

Mr. BUNKER. Yes.

Senator WAGNER. That ought to be prevented, too, should it not?

Mr. BUNKER. What do you mean?

Senator WAGNER. I mean it ought to be made very clear what the investor is nvesting his money in—whether he is investing it in, let us say, a corporation such as you represent——

Mr. BUNKER. Yes.

Senator WAGNER (continuing). Or whether he is putting his money in a new venture of some kind, into which the investment trust is going.

Mr. BUNKER. Surely, I think he should know, Senator.

I think there is one very interesting question. You see, it was my understanding from listening to you the other day that you felt that

possibly it was inappropriate for investment trusts to put their money into hazardous ventures.

Senator WAGNER. No, you misunderstood me.

Mr. BUNKER. I see.

Senator WAGNER. I say that is perfectly proper; and I want to see money go into those ventures, but the stockholder should know that that is what he is investing in.

Mr. BUNKER. Oh, fine; I agree 100 percent.

Senator WAGNER. If you examine my statement, you will find that; and I am sure you agree with me.

Mr. BUNKER. Yes, Senator, I agree with you one hundred percent.

Senator WAGNER. You agree with me, do you not, that the investor should know what type of investment he is making?

Mr. BUNKER. Yes.

Senator HUGHES. If he wants to make a certain sort or type of investment, he will go to a certain company that makes that type of investment?

Mr. BUNKER. Yes.

Senator HUGHES. But he does not always know that; and he may go to a company that makes speculative investments.

Mr. BUNKER. Yes; and he should know.

Senator HUGHES. Yes; he should know; and he should not think he is going to a company that is investing his money in a fairly safe way, if the situation actually is that the company to which he is going is making speculative investments.

Mr. BUNKER. Yes.

Senator WAGNER. I saw that statement in one of the newspapers; and I cannot understand, because I looked at my statement in the record and it was very clear.

Mr. BUNKER. Yes.

Senator WAGNER. The point I made was that I want to know if I am investing in a company which is going into some venture which is a pure gamble.

Mr. BUNKER. I agree one hundred percent, Senator; I think a man should know what he is going into.

Senator WAGNER. Well, I do not think there may be so much difference between us on this bill.

Mr. BUNKER. Yes.

Senator, I have a message from Judge Healy, asking me to state again that I have not attempted to deal with the problems of open-end companies, face-amount certificates, or installment-plan selling. I tried to make plain before that I was not attempting to deal with those problems, but I am glad to state it again.

Senator WAGNER. Yes.

Mr. BUNKER. Is that what you wanted?

Mr. HEALY. Yes.

Mr. BUNKER. Very well.

Senator WAGNER. There have been some real abuses in those phases?

Mr. BUNKER. Yes.

Senator WAGNER. No doubt we shall hear about that later on.

Mr. BUNKER. Yes.

Senator WAGNER (chairman of the subcommittee). Are there any other questions to be asked?

Senator HERRING. No; thank you.

Senator WAGNER. Shall we go on? I understand the cotton bill is still up for consideration in the Senate chamber.

Senator HUGHES. They are still on that.

Senator WAGNER. You and I are paired on that proposition.

Senator HUGHES. Yes; you are wrong and I am right, of course. [Laughter.]

Senator WAGNER. That so often is the case. [Laughter.]

It is so hard to find out when we are right and when we are wrong. Very well; who is the next witness?

Mr. BUNKER. Mr. Quinn will be the next witness, Mr. Chairman.

Senator WAGNER. Very well.

(The documents referred to and submitted by the witness, entitled, "Standard Statistics and Stock Price Indices," "Comparison of Investment Trust Performance With That of 1929 New Issues," and "Evaluation of Investment Trust Service to Investors," are as follows:)

STANDARD STATISTICS STOCK PRICE INDICES AND THEIR SIGNIFICANCE AS A MEASURE OF INVESTMENT PERFORMANCE

(Issued in support of statements made by Mr. Arthur H. Bunker before a subcommittee of the Committee on Banking and Currency of the United States Senate in connection with bill S. 3580)

The aim and purpose of this study is to describe the methods of computation of the Standard Statistics stock price indices as well as the underlying concept of market measurement, and to serve as a basis for comparison with the statements made by the S. E. C. in their study on "Investment Trusts and Investment Companies" appearing in House Document No. 70. It is also intended to demonstrate the impropriety of comparing the market behavior of an investment fund with the fluctuations of the Standard Statistics indices.

The Standard Statistics stock market indices constitute "base weighted aggregatives." This means that each constituent is weighted in a manner to influence the fluctuations of the index in accordance with the importance of the individual constituent security. *It should be noted that the weighting factor was intended primarily to influence future fluctuations of the index.* Each weighting factor consists of the number of shares of each stock outstanding multiplied by the price of the stock. Thus the market value is assumed to determine the relative importance of the stock and at the same time influence future fluctuations of the index in relation to the initial weight. (In case a corporation has two classes of common stock representing similar equities except for voting power, the total number times the average price of both issues is taken as the weighting factor.)

The average prices of the initial individual constituents for the year 1926 were taken as the base. In other words, the index in its price relationship is expressed in relatives for which 1926=100.

The main difficulty confronting the construction of such an index is the maintenance of a continuity in the series due to the repeated changes in the capital structures of the individual constituent companies. The possible various forms of changes in the capital structure are taken care of in the following manner:

(a) Split-ups and stock dividends are taken care of automatically inasmuch as the increased number of shares outstanding counterbalances price changes.

(b) Rights to stockholders to subscribe for additional shares at a certain price are corrected for in the following manner: The weighting factor is changed in accordance with the larger number of shares outstanding. The influx of new capital is corrected for by changing the original base. The total current market value of the stock outstanding including the proceeds from the sale of new stock is divided by the current value of the stock outstanding excluding these proceeds and the original 1926 base is then multiplied by this ratio to obtain the new base value. (The base value is increased in proportion to the influx of new capital.)

(c) In case of rights issued to (1) employees and (2) stockholders to subscribe to preferred stock issues or bonds or stock issues of subsidiary companies, the base value is corrected in a similar way except that the method of computation will result in lowering of the base value.

(d) Substitution of stocks necessitates a similar adjustment with regard to base value as well as number of shares outstanding. This results in a combination of the adjustments described under (a) and (b).

In constructing the indices the Standard Statistics Company aspired to achieve the following: namely, to construct stock market indices as representative as possible of the current situation while at the same time supplying the best possible record of earlier history.

The method of construction thus had to render the indices self-correcting for stock dividends and split-ups but had to make full allowance for the issuance of rights with a minimum effect upon the continuity of the indices. The previously described methods of computation fully achieve these aims.

(1) The indices give due weight to the constituents in accordance with the relative representation of the individual securities within the respective industries.

(2) The indices have the necessary flexibility to correct for price changes of individual constituents in connection with the issuance of rights, split-ups, and stock dividends without impairing the continuity.

The constituents of the daily indices were selected according to size of market value of the individual issues within their respective industries. In combining the three daily indices, the industrials, railroads and utilities, these subgroups were again weighted in order to correspond closely with the ratio of the total market value of all listed stocks representing these groups in relation to the total value of all listed securities. The weighting factors are 2, 1 and 2 respectively. *Crude as these weights appear on the surface, an actual test made at the year ends of 1926, 1929, 1935, 1937, and 1939 demonstrates that in reality these group weights superimposed upon the individual constituent weights result in a distribution closely identical with the actual ratio distribution of the market value of the three major stock groups.*

Undoubtedly, the stock-market indices as computed by the Standard Statistics Company constitute accurate measures of market fluctuations and maintain the continuity with a minimum of substitutions and changes within the constituents. In the industrial sector only two subdivisions were made since the beginning of 1927 to date—Crown Zellerbach was substituted for Abitibi Paper on February 12, 1932, and Loew's Inc. for Paramount on March 28, 1933. The other nine changes in that particular group were merely changes in names of securities or changes due to consolidations, namely, from Fleischmann to Standard Brands and from Armour of Illinois "A" to Armour of Illinois.[1]

It would be erroneous, however, to compare the fluctuations in the liquidating value of any investment fund with the fluctuations of the indices. *This statement is clarified by the fact that in actual investment practice it is impossible to follow the method employed in the construction of the Standard Statistics indices.*

An investor who at the beginning of 1927 invested a given fund in the 90 constituents of the Standard Statistics composite index and distributed his individual investments in accordance with the weights used by Standard Statistics (or in line with the market value of the individual issues) could not have maintained this investment and at the same time exercised the rights and made the substitutions as indicated by Standard Statistics. In fact such an investor had no funds to exercise his rights (for dividends paid do not enter the construction of the index). There was only one course left open to an investor, namely, to sell that portion of his rights which netted him such an amount of additional cash to enable him to exercise the remainder of his rights. The method employed by the Standard Statistics Company in constructing the stock market indices constitutes a theoretical concept of market behavior but cannot be put into actual operation. It is a mathematical shortcut to duplicate the percentage fluctuation in the liquidating value of a fund governed by a very complex set of investment operations and substitutions as shall be shown later in the text.

In order to test the validity of comparing the Standard Statistics indices with any investment fund we have recourse to two methods.

I. To sell such a portion of the rights which nets sufficient additional funds to exercise the remainder of the rights. This procedure should be subdivided into two separate operations, namely:

(a) An equal amount of money is invested in the 90 constituents at the average price level of 1926 and this fund is held constant with the exception of the substitutions made by Standard Statistics. Rights are exercised in the following manner: That amount of the rights is sold which nets sufficient cash to exercise the remainder. (The average price over the period that the rights are outstanding is taken as the sales price.)

[1] The S. E. C. in their report on "Investment Trusts and Investment Companies," on p. 852, footnote 62, cites 9 eliminations or substitutions in the Standard Index of 90 common stocks.

(*b*) A fund at the average price level of 1926 is invested in proportion to the market value of the individual issues. Thus the investment is distributed according to the Standard Statistics base weights. This fund is held constant except for the substitutions and exercising of rights as described under (a).

II. Another test initiates its operations with the fund distributed in proportion to the Standard Statistics weights, but in exercising subsequent rights liquidates such fractions of the individual holdings including the right issuing security to accumulate sufficient funds to exercise the rights issued.

The results of Test I are given in Tables I and II respectively. Table I compares the actual movement of the Standard Statistics averages with:

A. The method in which equal amounts were invested in the constiutuents at the end of 1926 with the rights being exercised by selling a sufficient amount of rights to obtain the cash necessary to exercise the remainder.

B. An investment allocation among the individual constituents at the end of 1926 in a proportion similar to the percent distribution of the weights of the Standard Statistics indices. Rights and corrections were taken care of in a way similar to that described under A.

The results of Test I, given in Tables I and II, show the actual behavior of the Standard Statistics indices compared with the course of the same indices reconstructed in the way described under I (a) and (b). (See page 6.) The findings disclose that, while the Standard Statistics averages of 90 combined stocks decline from a level of 100 at the beginning of 1927 to a level of 99.2 by the end of 1939, the reconstructed indices (a) without weighting, decline 24.1 percent and (b) on the same basis but weighted in accordance with the Standard Statistics distribution, decline 18.4 percent. The respective discrepancies by the end of 1935 amount to −12.7 percent and −13.8 percent. By the end of 1937 the differences were −20.1 percent and −18.3 percent, respectively.

TABLE I.—*Standard Statistics stock-price indices compared with reconstructed indices*

	1926 average	1929 high	1932 low	1933 high	1935		1937		1939	
					High	Year end	High	Year end	Year end	Percent deviations from St. St.
Standard Statistics 50 industrials	100.0	252.8	34.3	104.0	128.8	127.2	181.5	102.2	121.2	
Reconstructed indices:										
(a)	100.0	289.6	25.2	101.4	127.0	125.9	181.6	94.3	106.4	−12.2
(b)	100.0	280.6	29.3	104.4	129.3	128.1	184.3	98.1	117.4	−3.1
Standard Statistics 20 railroads	100.0	167.8	12.8	59.8	45.4	43.8	68.1	30.2	32.0	
Reconstructed indices:										
(a)	100.0	155.1	9.9	52.9	41.9	40.5	62.9	27.4	29.4	−8.1
(b)	100.0	170.7	11.2	57.5	44.6	43.6	67.0	28.9	30.4	−5.0
Standard Statistics 20 utilities	100.0	353.1	48.0	117.3	86.2	84.0	105.8	57.9	69.7	
Reconstructed indices:										
(a)	100.0	318.9	30.8	84.0	65.8	64.2	77.1	37.5	43.4	−37.7
(b)	100.0	244.7	26.0	68.6	51.7	50.4	62.1	33.6	40.2	−42.3
Standard Statistics 90 combined	100.0	253.5	33.4	98.8	107.8	106.7	149.6	83.7	99.2	
Reconstructed indices:										
(a)	100.0	266.2	22.7	86.8	94.6	93.2	132.0	66.9	75.3	−24.1
(b)	100.0	248.2	24.5	86.0	93.2	92.1	131.1	68.4	80.9	−18.4

(a) Equal sums of money were invested in the constituents in 1926. This fund held constant thereafter with rights being exercised by selling a sufficient amount of rights to obtain the cash necessary to exercise the remainder.

(b) The investment in the individual constituents in 1926 was made in proportion to the market value of the individual issues. The investments are distributed in accordance with Standard Statistics 1926 base weights. This fund was again held constant with the rights being exercised as described under (a).

TABLE 11.—*Standard Statistics stock price indexes compared with reconstructed indexes*

[Year end 1929=100]

	1929, year end	1935, year end	1937, year end	1939 Year end	1939 Percent deviations from St. St.
Standard Statistics 50 industrials	100.0	75.1	60.5	71.6	
Reconstructed indices:					
(a)	100.0	84.8	63.5	78.7	+9.9
(b)	100.0	83.5	63.9	76.1	+6.3
Standard Statistics 20 railroads	100.0	33.9	23.4	24.8	
Reconstructed indices:					
(a)	100.0	27.0	18.3	22.8	−8.1
(b)	100.0	29.6	19.6	23.9	−3.6
Standard Statistics 20 utilities	100.0	39.5	27.2	32.8	
Reconstructed indices:					
(a)	100.0	42.5	25.1	29.3	−10.7
(b)	100.0	39.7	26.5	32.9	+0.3
Standard Statistics 90 combined	100.0	62.5	49.1	59.2	
Reconstructed indices:					
(a)	100.0	62.6	44.9	55.3	−6.6
(b)	100.0	61.8	45.7	54.9	−7.3

(a) Equal sums of money were invested in the constituents at the 1929 year end. This fund held constant thereafter with rights being exercised by selling a sufficient amount of rights to obtain the cash necessary to exercise the remainder.

(b) The investment in the individual constituents at the 1929 year end was made in proportion to the market value of the individual issues. The investments are distributed in accordance with Standard Statistics 1929 year end base weights. This fund was again held constant with the rights being exercised as described under (a).

Table II displays a similar computation, but the actual as well as the reconstructed indices have the year end of 1929 as a base. In this reconstruction the weights obtaining at the end of 1929 were applied. The result of this method shows that the reconstructed Standard Statistics index of 90 combined stocks declined 6.6 percent from the end of 1929 to the end of 1939 if equal amounts were invested in each constituent and 7.3 percent if the investments were allotted in accordance with the Standard Statistics 1929 year end weights. The differences with regard to the year end 1937 are of the same order, while by the end of 1935 the changes in comparison to the 1929 year end are practically nil.

As previously stated the Standard Statistics Company constructed their indices to measure market fluctuations in accordance with the importance of the individual constituent securities and at the same time to maintain a continuous record by introducing an appropriate measure to correct for rights, split-ups, etc. *These indices, on the other hand, were never intended to duplicate the market fluctuations of any stock market sector or investment fund selected at random.* Consequently such comparisons can be of no actual value to the individual investor.

The second method completely duplicates the theoretical calculations of the Standard Statistics Company. This method enables the investor to follow the voluntary and involuntarysteps taken by the Standard Statistics Company in constructing their respective indices without the need of additional money being poured into the fund. From an abstract mathematical consideration the latter method is quite successful and does not incur such losses in capital assets as previously demonstrated under steps (a) and (b) of Test I. The second method, however, proves to be quite costly if put into actual operation, as shall be demonstrated in a subsequent paragraph describing the application of the two methods in investment practice.

While it is true that in their original and initial form the Standard Statistics indices constituted a weighted aggregate of their respective constituents, these weights have been continuously distorted since the beginning of 1927. This distortion is due to the fact that with changing capital structures, be it through rights or property acquisitions affecting the common-stock issues outstanding, etc., the more successful companies acquired unduly large weights in relation to the rest of the companies. For our purposes the reconstructed averages as given under Method I (b) constitute the significant test of whether or not these indices are

comparable to an average investment fund. While the mainipulation of an investment fund in the manner described under (b) appears quite feasible, the results would have been 18.4 percent less successful than those registered by the Standard Statistics index of 90 stocks over the period from the beginning of 1927 to the end of 1937 or 1939. For the period from the beginning of 1930 to the end of 1939 the investor would have done 7.3 percent worse than the Standard Statistics average of 90 stocks, while at the end of 1937 the discrepancy would have amounted to −6.9 percent.

The smaller discrepancy in the 1930–1937 or 1930–1939 period must be attributed to the internal change in the stock market behavior which took place in the years following 1933. This was a less active period for our economy. Artificial wage and material cost increases depressed railroad securities while the utility legislation in subsequent years oppressed the utility sector. At other times individual legislative measures influenced the market movements of a majority of the industrial issues, the upshoot of which was that the stock market lost its conformity of movement and that the major subgroups, such as industrials, railroads and utilities, moved in opposite directions, which had never been the case in earlier periods, at least not to such an extent and over such a time span. Applied to the stock-market indices these developments tended to counterbalance themselves, thus stabilizing the market indices from a short-term point of view. Measured against an earlier base, such as the end of 1926, the market displayed a marked decline in comparison with the indices weighted in favor of the leaders which in turn acquired new capital funds through the issuance of rights and acquisition of subsidiaries.

In their analysis of the performance of investment trusts, the S. E. C. in the January 3, 1939 report entitled "Investment Trusts and Investment Companies" makes the following references to the Standard Statistics averages.

Page 470, paragraph 1: "* * * Therefore it appears that once the management decision was made as to the proportion of the assets of the company to be placed in the different types of investments, the results obtained in particular years were approximately those which could be obtained from an "unmanaged' fund placed in the indexes used in this comparison."

Paragraph 2: "* * * In other words, for the years 1927–37, which included years of rising and declining prices, the typical large closed-end management company proper in a typical year performed not much differently from an 'unmanaged' fund represented by the 90 common stock index. Using the 90 common stock index as a basis of comparison, management of the typical investment company made no substantial performance contributions in the typical year to the investors in these companies."

Page 471, paragraph 2: "* * * It is estimated that the cost of operating such an unmanaged fund by a trustee operating under a suitable trust indenture would only be a fraction of one percent of the net assets per annum."

Page 477, paragraph 2: "* * * The performance of these diversified companies averaged about 9 points above the 90 common stock index relative for this period but was somewhat below the Standard Statistics index of industrial common stocks.

Page 852, paragraph 1: "* * * Not only was the investment company performance no better than an index of common stocks but it actually averaged somewhat less than the index over the 1927–35 period."

Paragraph 3: "The test implicit in comparison to such an index is that of an unmanaged fund. It will be interesting to determine whether or not the management of an investment company can, from year to year, perform as well as or better than an index which foregoes virtually all management."

Footnote 62: "An index of common stocks is analogous to an unmanaged fund which does not incur management costs and is fully invested, in proportion to the weights assigned in the index, in a list of twenty to a few hundred popular stocks. That it is essentially an unmanaged fund is illustrated by the fact that only 9 eliminations or substitutions in the Standard Statistics Co. index of 90 common stocks occurred during the 1930–35 period. The index is therefore particularly useful for comparison purposes since it eliminates the functions and costs of management and thereby makes possible an evaluation of management's contribution."

These comparisons presuppose two qualities of the Standard Statistics index of 90 stocks, namely, (1) that the St. St. index represents a cross-section of the popular common stock investment media listed on the New York Stock Exchange and (2) that the performance as to representation and continuity of the Standard indices is analogous to an unmanaged, random investment in a common stock

portfolio. *Based upon these erroneous presuppositions, the S. E. C. concludes that investment trusts of the management type have done slightly worse than an unmanaged fund.*

The impropriety of comparing the market behavior of an investment fund with the fluctuations of the Standard Statistics indices becomes quite evident if one considers that the Standard Statistics Company never intended to trace or record the investment performance of any given fund *but that it endeavored to construct a mathematical shortcut to duplicate the percentage fluctuations in the market values of the most representative security issues within their respective industries and that at the same time it aimed to maintain a continuity by properly correcting for changes within the capital structures of the constituents in connection with the issuance of rights, split-ups, stock dividends, etc.*

In their present form of construction, *the Standard indices cannot be duplicated in actual investment practice* (see page 5, paragraph 3). There are only two alternative methods by which it is possible to follow the underlying concept employed by the Standard Statistics Company in the construction of their index, namely, those listed on page 6 of this study under Test I (b) and Test II.

The application of Test I (b), which carries forward a fund invested in 1926 in proportion to the Standard weights with subsequent rights being exercised by selling sufficient amounts of such rights to net the necessary cash to exercise the remainder, proves that by the end of 1935 such a fund would show a decline of 13.8 percent as compared with the percentage fluctuation of the Standard Statistics index of 90 stocks and that the loss by the end of 1937 and 1939 would have amounted to 18.1 and 18.4 percent respectively.

The second test would have preserved the initial liquidating value of the fund but, in doing so, would have involved 29,970 individual investment operations for the period from 1926–1939. This is in contradistinction to the statement made by the S. E. C. that in the period from 1930–1935 the total index registered only 9 eliminations or substitutions. In actual practice it would have been necessary to go through 16,740 separate market operations for this period.[2] According to the Standard Statistics Company Base Book, subdivision C, page C–72, there were only 17 substitutions and eliminations in the combined index of 90 stocks from 1926 to 1939—10 in the industrial stocks, 7 in the utilities, and none in the rails.

TABLE III.—*Number of corrections and changes in the Standard Statistics index of 90 combined common stocks*

Year	Number of changes [1]	Resultant number of market operations, 1930–35 [2]		Year	Number of changes [1]	Resultant number of market operations, 1930–35 [2]	
1926	9	810		1934	17	1,530	1,530
1927	17	1,530		1935	17	1,530	1,530
1928	19	1,710		1936	15	1,350	
1929	48	4,320		1937	18	1,620	
1930	54	4,860	4,860	1938	10	900	
1931	30	2,700	2,700	1939	11	990	
1932	42	3,780	3,780				
1933	26	2,340	2,340	Total	333	29,970	16,740

[1] Actual count.
[2] Market operations refer to sales of fractions in individual holdings but are not identical with market transactions which can be much larger in number.

In other words the S. E. C. overlooks the changes necessary in exercising rights to subscribe to additional common stock, preferred stock, or bonds and also the changes in connection with the increases in common-stock capitalization incidental to the acquisition of additional proerties by the individual constituent companies.

We may thus conclude that the Standard Statistics averages constitute mathematical shortcuts to measure percentage fluctuations in the market value of the

[2] Inasmuch as this method necessitates the liquidation of fractions in the totality of the individual holdings, each correction in connection with issuance of rights or the increase in common stocks outstanding of any one of the constituents coincidental to the acquisition of additional property through the exchange of common stock results in 90 individual market operations. In order to avoid any controversy as to the actual amount of changes and corrections made by the Standard Statistics Company, we went through a physical count employing the records of the Standard Statistics Company in order to determine accurately the number of financial operations required by any fund in duplicating the Standard Statistics performance. (See Table III.)

most representative security issues, which cannot be duplicated in actual investment practice.

Actual investment experience from the beginning of 1927 to the end of 1939 proves that it is possible to approximate the Standard Statistics index by the application of 333 market operations with a final loss of 18.4 percent in the initial fund. A complete duplication would required 29,970 market operations in order to keep the initial fund intact.

It should be understood that the market operations represent changes in individual portfolio holdings and thus constitute the theoretical minimum of the sum total of perfect market transactions. The fact that the latter assumption is untenable in actual investment practice and that large expenditures have to be incurred through odd-lot and multiple-selling operations was disregarded.

APPENDIX. CONSTITUENTS OF STANDARD STATISTICS 90 STOCK AVERAGE

50 INDUSTRIAL STOCKS

*Allied Chemical & Dye (12–31–'25).
*Allis Chalmers (12–31–'25).
*American Can (12–31–'25).
*American Locomotive (12–31–'25).
*American Radiator & Standard Sanitary (5–2–'29).
American Radiator Co. (12–31–'25 to 5–1–'29).
*American Smelting & Refin. (12–31–'25).
*American Sugar Refining (12–31–'25).
*American Tobacco "B" (12–31–'25).
*American Woolen (12–31–'25).
*Anaconda Copper (12–31–'25).
*Armour of Illinois (7–11–'34).
Armour of Ill. "A" (12–31–'25 to 7–10–'34).
*Bethlehem Steel (12–31–'25).
*Briggs Mfg. (12–31–'25).
*Burroughs Adding Machine(12–31–'25)
*Chrysler Corp. (12–31–'35).
Dodge Bros. "A" (12–31–'25 to 11–26–'28).
*Crown Zellerbach (10–3–'32).
*Cuban American Sugar (12–31–'25).
*Eastman Kodak (12–31–'25).
*Endicott Johnson (12–31–'25).
*General Electric (12–31–'25).
*General Foods (8–29–'29).
Postum Corp. (12–31–'25 to 8–28–'29).
*General Motors (12–31–'25).
*Goodyear Tire & Rubber (12–31–'25).
*International Harvester (12–31–'25).
*International Mercantile Marine (7–23–'29).
*International Nickel (12–31–'25).
*International Common (1939).
*Kennecott Copper (12–31–'25).
*Kresge (S. S.) (12–31–'25).
*Loew's, Inc. (3–29–'33).
*National Biscuit (12–31–'25).
*National Cash Register (4–4–'33).
*Pullman, Inc. (12–31–'25).
*Radio Corp. (12–31–'25).
*Reynolds Tobacco "B" (12–31–'25).
*St. Joseph Lead (12–31–'25).
*Sears, Roebuck (12–31–'25).
*Standard Brands (9–13–'29).
Fleischmann Co. (12–13–'25 to 9–12–'29).
*Standard Oil of Cal. (12–31–'25).
*Standard Oil of N. J. (12–31–'25).
*Stewart-Warner (12–31–'25).
*Texas Corp. (12–31–'25).
*Timken Roller Bearing (12–31–'25).
*Twentieth Century-Fox Film Corp. (8–29–'35).
Fox Film "A" (12–31–'25 to 8–28–'35).
*Union Carbide & Carbon (12–31–'25).
*United Fruit (12–31–'25).
*U. S. Rubber (12–31–'25).
*U. S. Steel (12–31–'25).
*Westinghouse Air Brake (12–31–'25).
*Woolworth (F. W.) (12–31–'25)
Abitibi Paper (12–31–'25 to 10–2–'32).
International Mer. Mar. Pfd. (12–31–'25 to 7–22–'29).
National Cash Register "A" (12–31–'25 to 4–3–'33).
Paramount Publix (12–31–'25 to 3–28–'33).
International Paper "A," "B", and "C" (12–31'25 to 1939).

20 RAILROAD STOCKS

*Atchison, Top. & S. F. (1-'26).
*Atlantic Coast Line (1-'26).
*Baltimore & Ohio (1-'26).
*Canadian Pacific (1-'26).
*Chesapeake & Ohio (1-'26).
*Chicago & North West. (1-'26).
*Delaware, Lackawanna & Western (1-'26).
*Great Northern "Pfd." (1-'26).
*Illinois Central (1-'26).
*Lehigh Valley (1-'26).
*Louisville & Nashville (1-'26).
*New York Central (1-'26).
*New York, Chic. & St. Louis (1-'26).
*Norfolk & Western (1-'26).
*Northern Pacific (1-'26).
*Pennsylvania R. R. (1-'26).
*Reading Co. (1-'26).
*Southern Pacific (1-'26).
*Southern Railway (1-'26).
*Union Pacific (1-'26).

* Present constituents.

20 PUBLIC UTILITY STOCKS

*American Pwr. & Lt. (1–'26).
*American Water Works & Electric (1–'26).
*Brooklyn-Manhattan Transit (1–'26).
*Brooklyn Union Gas (8–24–'28).
*Columbia Gas & Electric (1–'26).
*Consolidated Edison of New York (9–22–'28). (Formerly Cons. Gas. of N. Y.)
Bkyln. Edison Co. (1–'26).
*Detroit Edison (1–'26).
*Electric Pwr. & Lt. (11–16–'31).
*Interborough Rapid Transit (1–'26).
*International Telephone & Telegraph (8–25–'28).
Mackay Cable Cos. (1–'26).
*National Pwr. & Lt. (1–'26).
*North American Co. (1–'26).
*Pacific Gas & Electric (1–'26).
*Pacific Telephone & Telegraph (1–'26).
*Public Service of New Jersey (1–'26).
*Southern California Edison (1–'26).
*Standard Gas & Electric (11–16–'31).
*Twin City Rapid Transit (1–'26).
*United Gas Improvement (8–2–'29).
*Western Union Telegraph (1–'26).
Commonwealth Power (1–'26 to 8–1–'29).
Consolidated Gas of Baltimore (1–6–'30 to 11–16–'31).
Peoples Gas of Chicago (1–'26 to 1–5–'30).
Standard Gas & Electric (1–'26 to 2–6–'30).
Standard Power & Light "B" (2–7–'30 to 11–16–'31).

* Present constituents.

Comparison of Investment Trust Performance With That of 1929 New Issues

(Issued in support of statements made by Mr. Arthur H. Bunker, before a subcommittee of the Committee on Banking and Currency of the United States Senate in connection with bill S. 3580)

I—RESULTS

The S. E. C. has claimed that the record of investment trusts has been no better than that of an unmanaged fund of 90 common stocks. Certain errors have been discovered which tend to invalidate the assumption that the 90-stock index constitutes an unmanaged fund, but this line of argument is outside the scope of this report. Our purpose is to make another comparison which is just as appropriate as that of the S. E. C., i. e., investment trust assets compared with the behavior of new issues floated in 1929.

The year 1929 is chosen as particularly suitable for the comparison, because 65 percent of all the investment trust securities which were offered in the years 1927 to 1935 came out in that single year. (See Table, page 195, Part II of the S. E. C. report, House Document No. 70.)

In the accompanying Table I we show the percentage of value left at the end of 1935 of the issues of corporate securities offered in 1929. Issues of financial and real estate corporations are excluded.

The percentages in Table I are comparable with the 56 percent [1] which is the portion of investment-trust assets which was conserved during the same period. From the table we see that the new issues of common stocks fared worse in all categories than the assets of investment companies. As for preferred stocks, the new issues of industrial companies did better than the trusts, but the issues of utility and railroad companies did worse. The corporate bond issues of all categories showed a better performance than the investment trusts.

To interpret the significance of the table it is necessary to decide with which type of security it is proper to compare the investment-trust assets. The decision can be made only after considering the purpose of an investor in buying into an investment trust in 1929, and what alternate choices were open to such an investor.

[1] This figure is estimated by correcting the 69 percent given by the S. E. C. (Part Two, page 476) for the conservation of assets between December 31, 1929, and December 31, 1935. The proportional difference between the end of 1929 and the average for the year is assumed the same as that difference in Standard Statistics average of 90 industrials. This adjustment is explained more adequately in Part II of this study.

TABLE I.—*Results of study on the performance of corporate issues floated in 1929*

[Only traceable issues included; distributions not credited]

	Amount in 1929	Value in 1935	Percent of 1929
COMMON STOCKS			
C1 Industrials	$1,622,000,000	$654,000,000	40
C2 Utilities	923,000,000	206,000,000	22
C3 Rails	343,000,000	111,000,000	32
C4 Total common stocks	2,888,000,000	971,000,000	33
PREFERRED STOCKS			
P1 Industrials	390,000,000	271,000,000	69
P2 Utilities	463,000,000	147,000,000	32
P3 Rails	55,000,000	10,000,000	18
P4 Total preferred stocks	908,000,000	428,000,000	47
BONDS [1]			
B1 Industrials	610,000,000	409,000,000	67
B2 Utilities	829,000,000	684,000,000	82
B3 Rails	362,000,000	230,000,000	64
B4 Total bonds	1,801,000,000	1,323,000,000	74
All securities	5,597,000,000	2,722,000,000	49
I. T. Investment trust assets (S. E. C. study—adjusted)			56

[1] Excludes issues maturing serially.

The following facts emerge from such a consideration:

(1) Investment trust securities were presented as speculative opportunities and must be compared with other securities of the same nature.

(2) Assets of investment trusts had a better performance record than did such of the new issues offered in 1929.

The contention that the investment trusts satisfied a demand for speculative opportunity rather than for investment in the purest sense is confirmed by data and arguments found in the S. E. C. report itself. Thus on page 195 of Part Two we find that during the years 1927–35, the new funds of management-investment companies proper [2] were derived from the following types of securities:

	Percent
Common stocks	46.1
Preferred stocks	10.2
Units of common and preferred stocks	34.2
Bonds and units of bonds and stocks	9.5
Total	100.0

The SEC comments as follows on the table from which these data are derived (pages 193-4):

"The greater part of the funds of this group of closed-end management investment companies proper and investment holding companies was raised by the sale of their common stock—about $2,354,000,000 or 58 percent of the total proceeds of security sales. In addition, substantial sums were collected through the sale of units consisting of common and preferred stocks [3] . . . Such units were offered by distributors as a means of combining the semi fixed income of preferred stocks with the possibility of capital appreciation through the ownership of common stock. In 1928 and 1929 when the popularity of common stock was used to stimulate the sale of the more 'conservative' preferred stock, units were extremely popular . . ."

The S. E. C. says further (page 196):

"Many of these preferred stocks and bond issues were sold by the sponsors with warrants or other forms of 'trimming' to provide the desired common stock 'kick' for investors."

[2] Excluding Atlas and Equity Groups which were also excluded in the S. E. C.'s comparison of investment trusts with Standard's 90.

[3] "* * * Units offered by some companies were split into their component parts as soon as their sale was consummated. In other instances the units were traded as such for some months or years after their original sale, and the component securities could not be separated from one another."

From these considerations it is obvious that the investment trusts served primarily those investors who were interested in speculative opportunities. Again to quote the S. E. C. (page 470):

"Furthermore, it is recognized that any determination of the quality of the performance of a particular company must include a consideration of the 'purposes or objects' for which the company was organized."

Since the investment trusts were offered as opportunities to participate in speculative appreciation it is appropriate to compare their performance with that of the other speculative opportunities which were presented at the same time, for it was among these that the investor who had decided to speculate had to choose.

Certainly, one of the alternatives was the purchase of the 90 seasoned high-grade common stocks which constituted the Standard Statistics average. But this was not the only possibility open to the investor, as is admitted by the S. E. C. on page 470:

"This comparison between the performance of investment companies and that of the common-stock index does not imply that the index is set up as a standard of performance, nor that no other approach is possible in the evaluation of the contribution of management. Thus one largely hypothetical problem that might be investigated is what the investors in these companies would have done had they not bought investment company securities."

Such an investor might well have bought the speculative issues of nonfinancial companies which appeared in 1929. If he had bought indiscriminately into all the issues of common stocks which fall into the categories we have considered, he would have had only 33 percent of his investment left on December 31, 1935. If he had bought into all the preferreds he would have retained only 47 percent. In either case he would have fared worse than if he had bought into the assets of the investment trusts.

A list of the most prominent companies included in the study appears as a special appendix.

II—STATISTICAL PROCEDURE EMPLOYED IN EVALUATING 1929 NEW ISSUES

General Remarks.—The object of the inquiry was to measure the decline to December 31, 1935, in the value of the new investment opportunities offered to the public in the form of corporate securities in 1929. The security issues included were taken from the compilations which appeared monthly in the "commercial & Financial Chronicle." Only issues floated by industrial, utility, and railroad corporations, and securities issued by companies organized to effect control of companies in these three categories were included. Securities representing flotations of financial corporations such as investment trusts, insurance companies, etc., have been excluded, as have securities issued to finance real estate activities. Short-term bonds and notes have been omitted, as well as serial bonds.

With the exception of the categories noted above, the study includes every issue which was recorded in the Chronicle. The total value of the flotations examined was $5.9 billion (see Table II, page 10). The Chronicle, in its own summary of the capital flotations for the year 1929 (January 18, 1930, page 366), gives $10.0 billion as the total of all corporate issues. The break-down of this total permits us to explain the discrepancy. The deficiency of $4.1 billion is made up as follows:

Investment trusts, trading, holding, etc	$2. 2	billion
Land, buildings, etc	0. 5	"
Miscellaneous	1. 5	"
Short Term Bonds and Notes	0. 1	"
Total	$4. 3	"

(In the classification "Miscellaneous" the Chronicle includes mainly insurance companies, banks, etc. However, some issues of mercantile companies appeared under this head and were included in our study.)

In comparing the totals for the various types of securities with those of the Chronicle, it must be noted that we have used a slightly different system of classification. For instance, some companies listed under "Public Utilities" by this source have been omitted as they actually are investment trusts.

The procedure of the study was to compare the value contributed by the purchasers of the new issues with what they had left on December 31, 1935, on the assumption that they paid no brokerage charges at the time of purchase,

engaged in no market operations in the interval, and received neither dividends nor interest.

The 1929 value of flotations was taken at the price to the public rather than at the par value of the bonds or preferreds issued. A rough examination indicated that the few issues which were sold at a premium were outweighted by the issues sold at a discount.

Issues which consisted of packages of preferred and common stocks were included under the classification of preferreds, the common stocks being considered as merely a bonus. In some cases, however, it was possible to infer from the terms of the offer a proper price to apply to each separate component of the package. In such cases the two types of stock included in the issue were segregated and placed in the appropriate classes.

The value of the issues on December 31, 1935, was computed at the market price which obtained at that time. Where no sales occurred on that date, the market price was taken as midway between the bid and asked. In cases where quotations had to be obtained from the "National Quotation Summaries" (as published by the National Quotation Bureau) a different procedure had to be used. In this source the bids and offers are listed separately as of the dates when they were entered. The market price at the end of 1935 was taken as an average of the most recent bid and offer. These compromises were necessary only in the case of certain inactive securities.

Wherever new common issues were offered by means of rights to existing stockholders at a discount from market price, an adjustment was necessary. In evaluating the issue at subsequent dates, the issue price could not be compared with later market prices. It therefore was assumed that the issue was sold at the market price at the date of issue (the ex-rights day) and altered the number of shares making the total contribution equal the actual amount of new cash received by the company. From this point of view, the stockholder bought in at the market price and at the same time received a stock dividend on his previous holdings which increased the number of his shares. The value of the issue at a subsequent date was determined by multiplying the adjusted number of shares by the market price at the later date.[4]

Cash dividends and interest received by the investor during the interval 1929 to 1935 were not included in the value of his holdings at the end of the period.

In cases where changes in the capitalization of a company occurred, such as stock dividends, stock splits, or recombinations, the value of the investment at the end of 1935 was taken as the market value of the new securities which the stockholder had received.

Similarly, where a company was reorganized, went into receivership, or was acquired by another corporation, the value was reckoned as the subsequent value of whatever consideration the old stockholders received.

Where rights were offered to stockholders subsequent to their acquisition of the issue, we assumed that they were sold at their average market price during the period when they were outstanding. The cash thus obtained was carried along as such to December 31, 1935. (The amount contributed by such rights to the 1935 value of the new issues was only a fraction of 1 percent of the total.)

A number of the issues which we examined were untraceable for various reasons. The proportion of untraceable issues in each category is shown in Table II. Among the common stocks, the reason for classifying issues as untraceable was in most cases that no quotation or other basis of valuation could be found. Among preferred stocks some issues were placed among the untraceables for other reasons. A preferred stock bought up and retired by the issuing company was considered untraceable; most such retirements occurred at the low of the market, and it would not be fair to assume that the investor got into cash at this time. Issues which had been called were also put into the untraceable class, unless the call was for the purpose of forcing conversion and succeeded in doing so, in which case we assumed that the stockholder converted. Bond issues which were called before 1935 were also classed as untraceable.[5]

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[4] The necessity for making the adjustment is obvious, for instance in the case of the offer to stockholders of 1,358,888 shares of J. C. Penney common at \$7 per share when the market price (ex-rights) was \$121. At the end of 1935 the same stock was selling at \$78. If we made no adjustment for the fact that the issue came out at a discount, we should conclude that the value which the stockholders received appreciated over 1,000 percent. But the \$9.5 million which the company obtained from the operation was not represented by the number of new shares issued to the stockholders, which were partly in the nature of a stock dividend. The actual number of shares which covered the \$9.5 million of new equity was only 79,000 $\left[= \frac{9{,}500{,}000}{121}\right]$. We therefore evaluated the issue on December 31, 1935, at \$6.1 million (=79,000 shares × \$78), and compared this with the \$9.5 million in 1929.

[5] An indication that this treatment of called issues made little difference in the final results will be found in the later discussion under B4.

TABLE II.—*Coverage of study on the performance of corporate issues floated in 1929*

	All issues in 1929		Untraceable issues in 1929				Traceable issues in 1929			
	Number	Amount	Number	Percent of total	Amount	Percent of total	Number	Percent of total	Amount	Percent of total
COMMON STOCKS										
C1 Industrials	395	$1,671,000,000	70	18	$49,000,000	3	325	82	$1,622,000,000	97
C2 Utilities	69	925,000,000	4	6	2,000,000	.2	65	94	923,000,000	99.8
C3 Rails	11	343,000,000					11	100	343,000,000	100
C4 Total Common Stocks	475	2,939,000,000	74	16	51,000,000	2	401	84	2,888,000,000	98
PREFERRED STOCKS										
P1 Industrials	176	444,000,000	47	27	54,000,000	12	129	73	390,000,000	88
P2 Utilities	71	466,000,000	3	4	3,000,000	.3	68	96	463,000,000	99.7
P3 Rails	4	55,000,000					4	100	55,000,000	100
P4 Total Preferred Stocks	251	965,000,000	50	20	57,000,000	6	201	80	908,000,000	94
BONDS [1]										
B1 Industrials	150	690,000,000	40	27	80,000,000	12	110	73	610,000,000	88
B2 Utilities	125	910,000,000	16	13	81,000,000	9	109	87	829,000,000	91
B3 Rails	18	362,000,000	1	6			17	94	362,000,000	100
B4 Total Bonds	293	1,962,000,000	57	19	161,000,000	8	236	81	1,801,000,000	92
All securities	1,019	5,866,000,000	181	18	269,000,000	5	838	82	5,597,000,000	95

[1] Serial issues omitted.

The sources used included Poor's and Moody's Industrial and Public Utility Manuals, Moody's Bank Manuals, Standard Statistics Corporation Records, Poor's Cumulative Service, The Commercial and Financial Chronicle, The Bank and Quotation Record, The National Quotation Service, The Annalist, and the Fisher Manual of Valuable and Worthless Securities.

(C 1) Industrial Common Stocks.

The industrial common issues included many put out by small companies whose subsequent fate was difficult to trace. In many instances the sources mentioned that the company had gone out of existence, but did not reveal the results of the liquidation. In such cases it was often obvious from an inspection of balance sheets that the common-stock holders received nothing for their equity, and where this seemed very certain the 1935 value was taken as nil.

In the event of mergers, the value of the new securities exchanged for the old was traced through to the end of 1935. If, as was the case in many instances, stockholders of a bankrupt company merely received the right to subscribe to stock of the new company, the immediate value of these rights was ascertained relative to the market price of the issue which could have been subscribed for. If we found that no immediate value accrued to the subscription right, we gave the old stock no value whatsoever.

(C 2) Utility Common Stocks.

We have here included 69 domestic and foreign issues of the 74 reported in The Commercial and Financial Chronicle during the year 1929. The five omissions were made up of two issues wholly or almost wholly purchased by parent companies (Illinois Bell Telehone, Louisville Gas and Electric "B"), and three investment trust issues mistakenly listed by the Chronicle as utilities (International Superpower, which later became Bullock Fund, Ltd., Electric Power Associates, and Utility and Industrial Corporation). Four issues, 0.2 percent of the total volume of utility commons, were untraceable: (1) American Service Corp., (2) Associated Telephone Utilities, Inc., (3) Charlestown, (Mass.) Gas and Electric, (4) Portland Electric Power.

Number 3 above was absorbed by the Massachusetts Gas Company, and the fourth issue, after a change of name to Pacific Northwest Public Service, was 99 percent held in a voting trust.

In those cases in which companies whose issues we were examining lost their identity only by change of name, no adjustment was required. In recapitalizations and receivership reorganizations, the new certificates or fractions of certificates were assumed to have been accepted by the holder of the original common shares.

(C3) Railroad Common Stocks.

Only eleven railroads or railroad holding companies offered new stock in 1929; seven of these issues came out through rights to stockholders.

(P1) Industrial Preferred Stocks.

Some of the preferreds were convertible into common stock and in the event that some portion of the issue was converted we used one of the following two methods in ascertaining the 1935 value of the shares:

1. If any quotation on the preferred was available we accepted it.
2. If no quotation was available we assumed that a practically complete conversion had been effected and used the 1935 price of the common multiplied by the number of shares into which the total issue of preferred was convertible.

(P2) Utility Preferred Stocks.

In this category we found the Chronicle listing 74 issues, of which we concerned ourselves with only 71. The three issues omitted were investment trusts: (1) American Utility General Corp., (2) Utility and Industrial Corp., (3) Central States Electric Corp.

Of three nontraceable issues, two were in receivership (Northern Indiana Telephone and South States Utilities) and no quotes were available. The third (Southern Gas Company) was called in 1930. It was thought that the most reasonable treatment of this called preferred was omission from the aggregate, as opposed to carrying forward the cash received at call (See P4).

(P3) Railroad Preferred Stocks.

No comments.

(P4) Total Preferred Stocks.

In case any objection is made to the exclusion of called preferred stocks as untraceable, it may be mentioned that there were only three such issues. At the date of issue their value totaled $13 million. If we assumed that the investor carried through the cash he received at call to the end of 1935, he would have had only $11 million of value. The inclusion of these values in the totals would not have sensibly affected the result of 47 percent.

(B1) Industrial Bonds.

No comments.

(B2) Utility Bonds.

125 issues were reported by the Chronicle. We traced 109 issues, and of the remaining 16, 7 were considered untraceable because the issues were not quoted, or because insufficient information was available, or because the company was liquidated. Eight issues were called before the end of 1935 and one matured during 1935.

(B3) Railroad Bonds.

Equipment trust certificates were excluded for the following reasons:

(1) The special nature of equipment trusts is such that they are in the main influenced by money markets rather than by the credit of the railroads.

(2) These are not considered to be investment opportunities for the average investor but rather for the large investor, such as insurance companies, trust funds, etc.

(3) It is difficult to obtain quotations on these issues as they are quoted on the basis of the average yields to maturity of the various maturities.

During 1929 there were 18 issues of railroad bonds (excluding two issues guaranteed by the Dominion of Canada).[6] Only one of these bonds (valued at $120,000) was untraceable, so that for all intents and purposes the 1935 total value of these bonds was complete. The 1935 value represents a preservation of 64 percent from the date of issue in 1929.

(B4) Total Bonds.

The 1935 value of all bonds issued in 1929 was 74 percent of their value at date of issue.

The treatment accorded the called and matured bonds (i. e. their exclusion as untraceable) had very little effect on this result. Had the assumption been made that the investor carried along the cash received at call as such, and the 20 called issues included on this basis, the 74 percent would have become 76 percent, with only a fraction of 1 percent change in the total.

(I. T.) Investment Trust Performance, 1929 to End of 1935.

Investment trust assets at the end of 1935 were 69 percent of the value at the end of 1929. (S. E. C. report, Part Two, page 476.) In order to make this figure comparable with the percentages which we had obtained for the new issues of 1929, it was necessary to correct it for the fact that investment trust assets were lower at the end of 1929 than during the months when the major portion of new issues appeared. We have adjusted the 69 percent by assuming that, at the dates when the common stock issues were floated, the investment company assets were greater than at the end of 1929 in the same proportion as the Standard Statistics average of 90 industrials. An average of Standard's 12 monthly price indexes for 1929, weighted by the value of the new issues appearing each month, was 211. On December 31, 1929, the Standard index was 170. We therefore decrease the 69 percent in the ratio of 170 to 211 to obtain the figure of 56 percent which appears in the table. The second percentage measures the conservation of investment trust assets between the months in 1929 when the new issues were floated and the end of 1935.

[6] These are in the nature of government rather than corporate bonds.

APPENDIX. MOST PROMINENT COMPANIES INCLUDED IN STUDY OF 1929 NEW ISSUES [1]

INDUSTRIAL COMPANIES

Name of company	Type of issue		
	Common	Preferred	Bond
Abbot Laboratories	x		
Allis Chalmers	x		
American Cyanamid	x		
American I. G. Chemical			x
American Metal Company	x		
American Radiator Company	x		
American Rolling Mill	x		
American Steel Foundries	x		
American Tobacco Company	x		
Anaconda Copper	x		
Atlantic Refining Company	x		
Bendix Corporation	x		
Bethlehem Steel	x		
Borg Warner Corporation	x		
Bulova Watch		x	
Case, (J. I.)	x		
Continental Can	x		
Cooper Bessemer	x	x	
Crown Zellerbach		x	
Cudahy Packing	x		
Diamond Match Company	x		
Dow Chemical Company	x		
Eastman Kodak	x		
Firestone		x	
First National Stores	x		
General Mills	x		
General Steel Castings			x
General Theatres Equipment	x		x
Goodrich	x		
Goodyear Tire & Rubber	x		
Grant, (W. T.)	x		
Gulf States Steel	x		
International Combustion		x	
Kelvinator	x		
Koppers Gas and Coke			x
Kreuger and Toll			x
Lorillard, (P.)	x		
Lautaro Nitrate			x
Ludlum Steel		x	
Macy, (R. H.)	x		
Mid-Continental Petroleum	x		
Minneapolis Moline	x	x	
Montgomery Ward	x		
National Dairy Products Company	x		
National Tea Company	x	x	
Oliver Farm Equipment		x	
Penney, (J. C.)	x		
Pittsburgh Coal			x
Procter & Gamble Company	x	x	
Radio-Keith-Orpheum	x		
Richfield Oil			x
Schulte-United 5c to $1 Stores			x
Sharp and Dohme		x	
Shell Union Oil		x	
Simmons Company			x
Spicer Manufacturing		x	
Texas Corporation			x
Thermoid Company		x	
Ulen and Company	x		x
Union Carbide and Carbon	x		
United Aircraft and Transport Company	x		
United Carbon	x		
United States Steel Company	x		
Warner Bros. Pictures	x		x
Warner Quinlan	x		x
Wesson Oil and Snowdrift		x	
Westinghouse Electric & Mfg. Company	x		

[1] The 838 issues traced in the study amounted to $5.6 billions at the time of flotation in 1929. Of this amount $3.0 billions, or 54%, was floated by the 100 companies listed in the appendix.

Appendix. Most Prominent Companies Included in Study of 1929 New Issues—Continued

PUBLIC UTILITIES

Name of company	Type of issue: Common	Preferred	Bond
American Telephone & Telegraph Co.			x
Associated Gas & Electric Company		x	x
Cities Service Company	x		x
Columbia Gas & Electric	x		
Commonwealth Edison (Chicago)	x		
Consolidated Gas of New York	x		
Consolidated Gas, El. Lt. & Pr. Co. of Balto	x		
Detroit Edison	x		
El Paso Natural Gas			x
Electric Bond and Share	x	x	
Engineers Public Service	x		
International Hydro Electric System	x		x
International Telephone & Telegraph Co	x		
Long Island Lighting		x	
Montana Power		x	
New York Steam			x
Pacific Gas and Electric	x		
Pacific Lighting Corporation		x	
Penn-Ohio Edison			x
Public Service of New Jersey	x	x	
Southern California Edison Company	x		x
Standard Gas and Electric	x	x	
United Corporation	x		
United Gas Company	x	x	
United Gas Improvement	x		
Utilities Power & Light			x
West Penn Power Company		x	

RAILROAD COMPANIES

Name of company	Common	Preferred	Bond
Alleghany Corporation	x	x	x
Canadian Pacific			x
Chesapeake and Ohio	x		x
Missouri Pacific			x
New York Central	x		
Pennsylvania	x		

Evaluation of Investment Trust Service to Investors by Comparison With Performance of Investment Rated Equity Recommendations as of September 30, 1929, After Initial Market Break

(Issued in support of statements made by Mr. Arthur H. Bunker, before a subcommittee of the Committee on Banking and Currency of the United States Senate in connection with bill S. 3580)

The preeminent position acquired by investment rating and advisory services as conservative investment counselors to institutional and individual investors dates back to the pre-war period. Banks, insurance companies, and trust funds have accepted the rating system of securities and its criteria of investment rank as the most reliable source of information. After the crisis in the banking system in 1933, the governmental regulative bodies also adopted investment-rating methods, thus giving official recognition to investment-rating agencies.

In view of the leadership secured and retained by these services, their recommendations at any time represent the contemporaneously accepted sound and experienced investment judgment. It is, therefore, significant to compare the performance of investment trusts with the recommendations of one of the best known investment rating and advisory agencies.

As a vantage point we take the recommendations made on September 30, 1929, after the market had broken from the Labor Day highs and canceled the greater part of the year's gains. At that time this investment service deemed the stock

market level particularly attractive for investors and submitted a list of about 50 stocks—of which 37 were given specific ratings—with half rating A or better (Aa in stocks corresponding to Aaa in bonds). The preponderance of the list that was given a rating was in industrials with considerable representation for railroads and for utilities, and, as a supplement, there were other stocks without rating.[1] But this supplement was, in turn, dominated by bank stocks at that time regarded to be on a parity with high-grade bonds.

We have taken that list in two forms (with and without unrated stocks), and computed the market vlaue of the list for the dates used in the S. E. C. investigation, namely, the end of 1929 and the end of 1935, after making due adjustments for rights and other capital changes. In order to reinforce the emphasis upon investment standing, we have weighted the list in accordance with the above rating by giving the A issues a triple weight, the Baa and Ba a double weight and everything below a single weight. In the list, inclusive of the issues that are not accorded a rating in the recommendations of September 30, 1929, we have given these unrated stocks a single weight, even though many of them were bank stocks which, judging by specific comments in prior letters during that year, were deemed of the highest grade. For convenience, we shall call the list confined to stocks with specific ratings portfolio No. 1, and the larger list, inclusive of the nonrated stocks, portfolio No. 2.

The performance of such portfolios constitutes a proper measure of what an "unmanaged fund" performed between the dates chosen by the S. E. C.

It is, therefore, noteworthy that the first portfolio of these investment rated and weighted common stocks, recommended in 1929, if held through 1935 had at the end of that year a value of 47.9 percent of the year end 1929 value; and that the second portfolio, augmented by another dozen issues, had a value at the end of 1935 of 46.6 percent of the year end 1929 valuation.[2] By comparison, the S. E. C. itself found that the performance of typical closed-end investment trusts, aggregating 49 such organizations, had at the end of 1935 a price value (exclusive of intervening distribution) of 69 percent of the end of 1929. The performance of the closed management investment trusts was, thus 44 percent higher than a typical investment portfolio selected by one of the outstanding public investment advisors of the period and since.

To illustrate the validity of the method adopted herein of using the 1929 recommendations as a dual index of investment funds—first of what a well chosen 1929 investment fund was, and, secondly, what would have happened to such a fund if retained without management to 1935—we need only call attention to the differential behavior of the constituents of the list by investment rating. The summary table of these recommendations records for the period from the year end 1929 to the year end 1935 the performance of the total portfolio as well as by respective investment rating classes.

Summary performance records year end 1929–35 of investment recommendations in 1929 as unmanaged portfolio by total and by investment classes

[Adjusted for stock dividends, stock splits and rights, but not for cash dividends]

	Weights	Weighted totals		Percent decline
		Dec. 31, 1929	Dec. 31, 1935	
List of recommendations of September 1929:				
Aa	3	$1,200	$736.50	−38.6
A	3	3,900	2,004.00	−48.6
Baa	2	2,000	856.00	−57.2
Ba	2	1,000	472.20	−52.8
B	1	400	46.00	−88.5
Caa	1	100	7.30	−92.7
Total		8,600	4,122.00	−52.1
Total nonrated stocks	1	1,300	495.50	−61.9
Combined list augmented with nonrated stocks		9,900	4,617.50	−53.4

[1] The large representation of railroads constitutes in itself a definite market judgment as to group selectivity. The service was obviously acting on historic precedent—good for previous cycles—that the railroad industry would be less cyclical than the general industry.

[2] Detailed tabulation attached.

The orderly gradation of the depreciation from under 40 percent for the Aa, or the highest rated stocks, with a triple weight, to about 90 percent for the B and Caa, with a single weight of one, clearly suggests that the more seasoned securities of investment merit had a higher survival ratio than those of low investment standing. The depreciation in the nonrated stocks approximates the shrinkage in the Baa rated equities, confirming the opinion conveyed earlier herein, that they contained a large number of stocks, which in 1929 had a fairly high investment standing.

The correspondence between the ratings and the capital conservation is thus incompatible with the popular notion of Wall Street critics that in 1929 everybody's judgment was no good and all valuations worthless. While the Ba group turned out to be somewhat better than Baa stocks, the fact remains that the rating ranges to which we accorded a weight of one, experienced a decline double that of the groups with a weight of three. The depreciation was inescapable, because of the economic and monetary events of the American and world major depression and deflation on the greatest scale that we and the world at large had previously experienced, with attendant debt repudiation, currency devaluation, and all around scaling down of capital values.

List of common stock recommendations as of Sept. 30, 1929, converted into an unmanaged portfolio [1] for the period end 1929 through end 1935, weighted in accordance with their investment rating and adjusted for capital changes

Common stock recommendations as of Sept. 30, 1929	1929 rating	Prices Dec. 31, 1929	Prices Dec. 31, 1935	Adjusted Dec. 31, 1935, prices	1935 as per-cent of 1929	Weighted investments		Adjustments necessary to make 1935 prices comparable to 1929 (not adjusted for cash dividend). Stock dividends and stock splits.	
						Dec. 31, 1929	Dec. 31, 1935	Rights	Remarks
Atchison	Aa	224	59¾		26.7	300	80.1		
General Electric	Aa	61⅞	38¼		61.9	300	185.7		
Standard Oil of New Jersey	Aa	66⅛	51¾		78.3	300	234.9		
American Telegraph & Telephone	Aa	222½	155½	174.88	78.6	300	235.8	22⅝–16	
Total		574.50		324.63		1,200	736.5		
Alabama Great Southern	A	123	37¾		30.7	300	92.1		
Atlantic Coast Line	A	167	30½		18.3	300	54.9		
Norfolk & Western	A	227¼	209		92.0	300	276.0		
Pennsylvania R. R	A	74¼	31⅜		42.3	300	126.9		
Allied Chemical	A	265	157⅝	165½	62.5	300	187.5		5 percent stock dividend 1930.
Borden	A	66½	26½	27⅜	41.2	300	123.6		3 percent stock dividend 1930.
International Harvester	A	80½	61¼		76.1	300	228.3		
Union Carbide	A	79	71¾		90.9	300	272.7		
United States Steel	A	171	48½		28.4	300	85.2		
Westinghouse Electric	A	144½	97½	106¾	74.0	300	222.0		½ share Radio Corporation in 1933; ¼ share in 1935.
Consolidated Gas of New York	A	100⅛	31¾		31.7	300	95.1		
Shawinigan Water & Power	A	74⅜	20		26.9	300	80.7		
United Gas Improvement	A	33½	17¾		53.0	300	159.0		
Total		1,606		859.25		3,900	2,004.0		
Baltimore & Ohio	Baa	116½	16¾	17⅞	15.4	200	30.8	1⅝–½	
Chicago & Northwestern	Baa	85	3		3.5	200	7.0		
New York, Chicago & St. Louis	Baa	132	17½		13.3	200	26.6		
Southern Ry	Baa	136	14¼		10.5	200	21.0		
American Smelting	Baa	72⅞	60½		83.0	200	166.0		
International Business Machines	Baa	162	177	198¼	122.4	200	244.8		5 percent stock dividend 1930, 5 percent 1931, 2 percent 1934.
Johns Mansville	Baa	125	95¼		76.2	200	152.4		
Sears Roebuck	Baa	89¼	65¾	69¾	78.2	200	156.4		4 percent stock dividend 1930, 2 percent 1931.
United States Realty & Improvement	Baa	60⅝	11		18.1	200	36.2		

Electric Bond & Share	Baa	85⅝	16⅛	6⅜	7.4	200	14.5		Four 1½ percent stock dividends in 1930, 1931, 1932, and reverse split of 1 for 3 in 1932.
Total		1,064.88		493.75		2,000	856.0		
Bangor & Aroostock	Ba	64	42		65.6	200	131.2		Each share Drug, Inc., received 4/10 share United Drug.
Chicago Rock Island & Pacific	Ba	114½	1⅝	3¼	2.8	200	5.6	2¼–⅞	Each share Drug, Inc., received 5/10 share Sterling Products.
Drug Inc. (United Drug)	Ba	79⅝	13¼	58	72.8	200	145.6		Each share Drug Inc., received 2/10 share Bristol Myers.
International Telephone and Telegraph.	Ba	74¾	13⅛	15⅝	20.9	200	41.8	3½–1½	Each share Drug, Inc., received 2/10 share Vick Chemical.
Pacific Lighting	Ba	76	51½	56¼	74.0	200	148.0	5⅝–3¾	Each share Drug, Inc., received 1/10 share Life Savers.
Total		408.88		175.13		1,000	472.2		
Erie R. R	B	56½	12¼	12⅝	22.4	100	22.4	¾–1/16	
New York, New Haven & Hartford	B	111¼	4		3.6	100	3.6		
St. Louis-San Francisco	B	107⅝	1⅜		1.3	100	1.3		
Engineers Public Service	B	40¾	7½	7⅝	18.7	100	18.7		2 percent stock dividend 1930.
Total		316.12		25.63		400	46.0		
Boston & Maine	Caa	100	7¼		7.3	100	7.3		
American Superpower	No rating	25⅝	2⅝		10.3	100	10.3		
Stone & Webster	do	81	14⅝		18.1	100	18.1		
United Corporation	do	32¼	7⅛		22.1	100	22.1		
American International	do	38¼	10⅝	11	28.8	100	28.8		4 percent stock dividend 1930.
General Public Service	do	35⅞	3⅞	4⅛	11.5	100	11.5		6 percent stock dividend 1930.
Continental Insurance	do	59¾	42¼		70.7	100	70.7		
Fidelity Phoenix	do	63	43½		69.1	100	69.1		
Home Insurance	do	42½	40½		97.5	100	97.5		
National City	do	212	39		18.4	100	18.4		
Chase National	do	155½	43	44¼	28.5	100	28.5		1 share Amerex for each 10 shares of Chase.
Guaranty Trust	do	675	309½		45.9	100	45.9		
Bank of Manhattan	do	120	32½		27.1	100	27.1		1 share New York Title & Trust for each share Bank of Manhattan (Dec. 4, 1935). (No value.)
New York Trust	do	256	121½		47.5	100	47.5		
Total		1,975.75		712.50		1,300	495.5		

[1] Converted by the present compilers.

Senator WAGNER (chairman of the subcommittee). Will you proceed, please, Mr. Quinn?

STATEMENT OF CYRIL J. C. QUINN, VICE-PRESIDENT, TRI-CONTINENTAL CORPORATION AND PARTNER OF J. & W. SELIGMAN & CO., NEW YORK CITY

Mr. QUINN. Thank you, sir.

Senator WAGNER. Mr. Quinn, you represent the Tri-Continental system?

Mr. QUINN. Mr. Chairman, I should like to begin by explaining that I am a vice president and director of Tri-Continental Corporation and of the four other investment companies that are associated with it. I am also a member of the firm of J. & W. Seligman & Co.

Like Mr. Bunker, in my discussion I shall confine myself to only the closed-end companies. I am not going to talk about open-end companies, unit-certificate companies, or those other types of companies with which I am not familiar.

I am proceeding on the assumption that you are not interested in generalities, neither are you interested in any extended discussion of the detailed, technical draftsmanship of the bill—although I must say that in some sections it is rather ambiguous, in a few sections it is rather contradictory, and in many places it is so vague that it is very difficult to comment successfully upon it.

I assume that what you really are interested in is in knowing what is our position with respect to regulation—that is the first thing; second, what sections I think are in the bill that should not be in it—that is the second thing; third, what, as a person with some practical experience, I think of the way that some principles with which we agree have been worked out, in those cases where we disagree with the manner of working them out.

In other words, I am proceeding on the assumption—and this is confirmed by the way the hearing has gone—that you welcome an honest and sincere attempt to help you gentlemen work out workable and reasonable regulations.

Let me cover the first point, as to my position with regard to regulation.

Senator HERRING. Mr. Chairman, I wonder if Mr. Quinn cannot address the Secretary, and then we shall all hear better, down here, and I think you will hear just as well, will you not?

Senator WAGNER. Yes, of course. Incidentally, I do not want to be critical at all; I know we all do it; but if we could refrain as much as possible from conversation, we shall all be helped very much.

I am as much guilty of that as anyone.

Senator HUGHES. I wonder if the Senator would not be in a better position up here at this end of the table.

Senator HERRING. I can hear all right; I am just thinking about some of the rest.

Mr. QUINN. I am sorry.

If I may readvert to our position with respect to regulation, Senator: In 1937, we, like Mr. Bunker, appeared at a public hearing of the S. E. C. in connection with the investigation and hearing on our companies. That was part of the general investigation of all investment companies. The chairman of the companies I represent at that

time stated that he felt some measure of governmental regulation of investment companies was desirable; he said he felt that if it was done on a proper basis, it would result in benefits to the holders of investment-company securities and to the public.

That was our position then, and that is our position now.

I might add that the statement of policy, which contains certain specific recommendations and certain general recommendations about what a proper regulatory bill ought to be, was sent out to all the shareholders of the companies. Some 40,000 shareholders got that statement at that time.

Now I come to the second question which I think you are interested in: That is, What parts of the present bill do I think have a proper place in a sound regulatory bill?

Mr. Bunker has set down certain principles. I shall try to elaborate those somewhat and to tie them in to the specific bill under discussion. I must add, however, that these things which I think should be in a regulatory bill, I think should be there in principle. I say that because I think there are many reservations with respect to the way in which they are put in there.

However, in principle I think a proper regulatory bill should contain (1) a provision for the registration of investment companies; (2) a provision for classification and subclassification of investment companies, although I think that the classifications used in this particular bill are illogical and absolutely misleading. I refer to the fact, for instance, that a company is called a trading company, for instance, because it has senior securities outstanding—which has nothing to do with whether or not it is a trading company. However, that is a further detail.

The third point that I have in this connection is I think a proper regulatory bill should contain provisions requiring the approval of stockholders for any change in fundamental policy. However, this is not a subject which is easy of solution; and Mr. McGrath, another one of our group, will later explain to the committee some of the difficulties encountered in this respect, under the provisions of this bill.

Fourth. I agree that there should be a prohibition against short sales and participations in pools or similar accounts.

Fifth. I think there should be prohibition against any direct sales or purchases of securities or other property between the investment companies on the one hand and their officers, directors, sponsors, and 10 percent shareholders, on the other hand. I say "10 percent," because that is the rule laid down in the other laws as to the person who has to report his holdings. This should not, of course, prevent the payment of salaries, management fees, and customary charges for agency services; and you will also hear from some other gentlemen, who are going to appear later, that a flat prohibition of this kind has certain disadvantages to particular companies. I think you gentlemen ought carefully to consider their viewpoint in connection with that.

Sixth. I think there ought to be requirements for adequate representation on boards of directors of persons independent of the management or sponsors.

Seventh. I think there ought to be a prohibition on loans by investment companies to officers, directors, or sponsors.

Eighth. I think there ought to be a requirement that all management or investment advisory contracts be submitted to stockholders. I cannot, however, agree that the basis of compensation under such contracts or the compensation of officers and directors should be limited in the manner prescribed in the proposed legislation. Furthermore, I see no reason why certain existing contract rights should not be recognized and respected.

Ninth. I think you might well put in provisions along the lines of section 16 of the bill with respect to changes in the board of directors, which should go far toward preventing the transfer of control without the stockholders' knowledge and consent; and in that connection I think you will recall that the witnesses on the other side said that went to the root of one of the principal cases that they cited.

Senator WAGNER. You approve of that?

Mr. QUINN. I think that is right, sir.

Tenth. I think there should be provisions with respect to proxy regulations, partly because I believe some form of proxy regulation is desirable and partly, I am afraid because the companies in the group that I represent are already subject to the proxy regulation which now applies to companies listed on national securities exchanges. However, I should like to say, parenthetically, that the present proxy regulations, to my mind, work out to the utter confusion of the poor stockholder; because it seems to me that this regulation requires so much information that the stockholder does not get a clear picture of it. Nevertheless, that is quite apart from this discussion.

Eleventh. I agree with the attempt to provide for underwriting by investment companies, but I think the present provisions ought to be tuned in carefully to the actualities of how that thing works out.

Twelfth. I approve whole-heartedly of the theory of those sections of the bill which are designed to provide shareholders and the public with full, complete, and periodic information. I disagree very strongly, however, with some of the methods proposed in this bill to achieve that objective.

I wish to make clear that when I say I agree in principle with this not inconsiderable portion of the bill, I must honestly point out that neither I nor any experienced person can agree with the way it is all worked out. The present bill is extremely intricate—perhaps necessarily so, although I doubt it. It does seem to me possible for draftsmen to work out a bill which would embody the above prohibitions and requirements, in order to prohibit certain things, and require certain other things in a way that would be clear, specific, and understandable. You would then have a bill which in my opinion would go as far as legislation can go to protect the investors against the abuses that have been revealed and against possible repetition of those abuses, without putting the management in strait jackets and without treating the investors like incompetent children.

I realize that this is not an easy task. I should like to be able, Senator, to come here and say that here are a few amendments which we propose and which, if accepted, would in our opinion make this much of the bill reasonable and workable.

That, however, is not really possible. There is hardly a paragraph and certainly not a section which, in my opinion, does not require revision; and the real point I want to make is that no one will get

anywhere in that necessary revision until someone has winnowed out those portions of the bill which have nothing to do with and nothing to contribute to reasonable and workable legislation.

Senator WAGNER. Are you going to enumerate those?

Mr. QUINN. I am going to take up specifically those sections that I think ought to be out of here.

Senator WAGNER. All right.

Mr. QUINN. I understand the approach of the S. E. C. to this problem, even though I cannot say I sympathize with it. They have seen wicked things happen, and they want to prevent their recurrence. This is very understandable. I doubt if anybody has ever gone down to see them and has said a kind word about investment companies, on a voluntary basis. They have seen only the one side of the picture, and they probably have been too busy chasing troubles to familiarize themselves with day-by-day, technical details of operation of investment companies, as run by decent and reasonable people.

We are just as anxious as they are to see the wrongs stopped; but I think it is only more natural for us to be conscious of the fact that in trying to cure a wrong, you may be doing a great deal of unnecessary harm.

May I reiterate my statement that I believe that if you will write a bill containing the prohibitions and requirements I have mentioned, and requiring the fullest publicity of any company's affairs, you will have gone as far as it is feasible to go toward according protection to the investor.

Of course, you can go at it and you can iron out every possibility of evil and every possibility of wrongdoing in this business, just as you can in any other business; but I think that when you get through such a process as that you will have rather effectively destroyed the business, in doing so.

I know you gentlemen are too experienced to think that you can set up a bill which will stop wrongdoing. Certainly, one wonders, in considering the cases that have been cited in these hearings, if the enactment of one more law will deter people from doing what they should not do. They certainly did not show very much compunction about breaking the existing laws in these cases. I know also that you gentlemen are too experienced to think that laws are going to prevent people from losing money; because you cannot do that; you cannot endow them with good judgment and foresight.

I do feel, however, that a bill such as I have suggested will go a long way toward curing all the revealed abuses, insofar as proper legislation can cure them. If you will review in your mind the abuses that have been presented to you by the statements here, I think that you will agree that, to the extent that it is legislatively feasible, you will have met the problem.

It will not go the length of this bill; but this bill attempts, on the basis of a short experience of 10 years, to legislate for all times and to legislate for all contingencies. That is just too big a job. Would it not be wiser to restrict the present legislation to those things on which the case is clear—those things which should be stopped, things the recurrence of which should be prevented?

But do not try in an unrealistic zeal for perfection to cure in one omnibus bill all the faults which have been revealed and to prevent all the abuses which might happen. That is bound to freeze

into the form of law one single solution of these problems, many of which are not solved.

I come now to those portions of the bill which in my opinion go far beyond the proper limits of sound regulatory legislation.

For instance, the present bill prohibits interested transactions between investment companies and persons closely associated with investment companies. That is sound. That will stop the cases you have heard of—cases of dumping and of improper transactions among the interested parties.

It then provides for independent directors to review and scan all transactions. I think that is sound. But having set up these two cures of a possible evil, the bill then proceeds to isolate those who might conceivably be affected by those evils. In effect, the bill dictates who can be directors of investment companies and under what circumstances and conditions they can act.

Now, Mr. Chairman, we have heard a good deal of talk about pyramiding; but isn't this thing in effect a type of pyramiding.? You put one prohibition on, and then put a second prohibition on, and then you put a third on top of those two. I think that the first two are sound; I think the third is unsound.

This bill subjects directors of investment companies to a degree of bureaucratic control which is demanded of the directors of no other form of business. It changes the management of certain companies without consulting stockholders as to their wishes. This is discriminatory, and, I think, unfair to certain classes of persons.

The real difficulty is that it attempts to solve a possible conflict of interests by making it virtually impossible—and we say that advisedly—for investment companies to retain or replace competent and experienced directors.

This is so important a part of this bill and so vital to the future operation of investment companies that, with your permission, our group proposes to deal with that specific item in more detail a little later on, Senator.

Now, I come to another provision of the bill which I think is a unique one. It was discussed in the committee the other day. It practically prohibits, by this section, any person from starting an investment company if within 5 years he has started another investment company. Now, this seems to me to put the cart before the horse, with a vengeance. The evils which it is designed to cure are covered by other provisions of this bill and also by the proper enforcement of the disclosure provisions of the Securities Act.

Now, Mr. Chairman, I don't want to be thought facetious, but it seems to me that the insertion of this provision shows a most lamentable lack of confidence in the rest of the bill. The bill is designed to prevent recurrences of abuses; but the authors are so uncertain of its effects that they say, "At least we will see that these abuses can recur only once every 5 years."

No matter how conpetent and successful a man is in handling other people's funds, he cannot set up another company, even though it may be designed to meet the wishes and needs of a particular group of investors, unless the Commission permits him to do so. This seems to me very questionable, indeed; I certainly question the propriety of including this kind of a provision in this bill.

I should like to refer next to certain prohibitions of the bill dealing with the formation of investment company systems. In relation to this subject you also have to think of those sections of the bill which are designed to prevent what might be called system operations through affiliations. Other sections of the bill prohibit cross-ownership and circular ownership. The declared purpose of the bill is to prevent unlimited pyramiding, but its direct effect is to limit even first-degree ownership in the future. Why would it not be possible to permit first-degree ownership, prohibit pyramiding—which is not involved very largely in first-degree ownership—and subject dealings between companies in the same system to the same type of prohibitions applying to self-dealings? If this were done, I think the possibilities of abuses which might be found in investment-company systems could be eliminated without destroying the possibility of system operation in much the same manner as the system operation of fire insurance companies.

There may be many reasons, primarily that of economy of operation, why joint management of a group of companies is desirable.

In fact, I am inclined to feel that if you thus destroy the possibility in the future of investment company system operations, you may well wash out one of the only feasible methods of providing good management for a company with small resources, at a reasonable cost. That is the second thing which I think should be vitally changed before it should be included in this bill.

I now come to another provision which seems to me to have no place in this bill: That is the section imposing a limitation on the size of investment companies.

Now, Mr. Chairman and Senators, any limitation on size is a very novel idea as far as legislation is concerned.

Senator Hughes. A limit to $150,000,000?

Mr. Quinn. Well, I want to point out, Senator, that that $150,000,000 limitation does not mean exactly what it says: because not only is there a limitation on size but there is rank discrimination between the size permitted of various types of companies. A diversified investment company, as defined in this bill, is restricted to $150,000,000; a securities trading or securities finance company is restricted to $75,000,000.

Now, sir, the argument that was advanced in favor of that differentiation was diversification; but the only distinction which there may be, under that definition, between a diversified investment company and a securities trading company may be that the securities trading company has a small amount of preferred stock or bonds outstanding. That has nothing to do with diversification. The only difference may also be that one company holds $10,000 of the securities of another investment company. That has nothing to do with diversification.

Not only is there no justifiable reason for this discrimination, but the whole idea of limitation of size is a novel departure in lawmaking. I shall not go into this matter any more fully, because in the further discussion of the details of the bill we should like to take this up again.

Senator Wagner. Of course, I have always had doubts about that, myself; but I am not an expert on this question, by any means.

Mr. QUINN. Senator, I think there is——

Senator WAGNER. I may want to go further than you do. I do not know; that is a matter of future determination.

However, with the other regulations, I do not particularly see the necessity of that; although, as I say, I want to hear from those more expert on the subject than I.

Mr. QUINN. I should like to go next to another subject which I think has no place in the bill. The bill before you has in section 18 a provision regarding the future capital structure of investment companies. It provides that in the future an investment company can have one, and only one, type of security—common stock. Bonds, debentures, preferred stock are all to be legislated out of future existence.

The prospective purchaser, in the future, is therefore going to be dictated to by the Government, in his choice of the type of security he wishes to buy. He is to be told that he can have one thing and one thing only.

I do not think that even the Public Utility Holding Company Act went that far; but this is so important and serious a matter that I should like to deal with it later at greater length.

Senator HUGHES. I am very much interested in that.

Mr. QUINN. Well, Senator, it is a rather complicated subject; it is a rather difficult subject; it is a very extensive subject. If you do not mind, Senator, I should rather confine myself now to an over-all review, and come back to that at some later time, if I may do so, with your permission.

Senator HUGHES. Very well.

Mr. QUINN. I now come to a section and a whole set of prohibitions which I think go way beyond the bounds of reasonable legislation. I refer to section 19, which deals with dividends.

After listening to the hearings, this subject is even more difficult to discuss than it was before. Mr. Smith, in discussing it the other day, said that one section means something that it does not say; and Judge Healy stated that he does not agree with it and is not yet ready to discuss it.

I recognize the limitations there have been on his time, but I just want to mention that point.

It does mystify us a little bit as to what is really intended; but I should like to cover some of the provisions of this section, as they have been written into the bill.

I shall not take up your time with a discussion of paragraph (a) of section 19, except to point out that it raises many important questions. When you are dealing with a definition of income of investment companies, do not think it is a simple matter. The income account of an investment company is affected seriously by the recurrent capital gains and losses which are inevitable. If you try to say that the only income you can qualify as income is net income from interest and dividends, you run smack against tax laws, you run right against and across State laws; and even then it is not attuned to the realities, since you can have income from other sources, under this bill, such as underwriting. This is a rather technical question, and I do not want to take up your time with it; but I should like to pass to another portion of that same section.

Section 19 (a) (1) provides that if a dividend is paid from other than what is called aggregate undistributed income from interest and dividends, the man who receives the dividend must be given a reasonable opportunity to invest such portion of that dividend as the Commission shall prescribe in the securities of the company without the payment of any sales load. This is intelligible, although highly controversial, if applied to the open-end companies; and Mr. Smith has said that that is what is intended. But that is not what the bill says.

Now let us look at the situation of the closed-end companies, as the bill is now written. It states that a closed-end investment company, when it pays a dividend of this sort, has to offer rights equivalent to a portion of that dividend to its stockholders. First, you have the not inconsiderable expense of registering that stock with the S. E. C. for such an offer; next you have the expense of communicating with the shareholders, in making this offer. What is the result? You offer shareholders the right to subscribe to stock, presumably at liquidating value, because that is what another section of the bill practically says; but these stockholders who are offered this right may be able to go out into the market and use that dividend to buy more stock of this investment company at a discount. Certainly, in many cases at the present time this offer provision and the offer would be silly and futile, and it would really be expensive.

Consider, however, the situation of closed-end companies with more than one class of securities. The dilemma is impossible. What is the justification for offering preferred shareholders such a right? They are entitled to an agreed amount of dividend, an agreed liquidation on dissolution; and the source of the income does not in any way affect their ultimate contract rights. If you give them anything extra, it is nothing but a pure gratuity at the expense of the common shareholder.

However, aside from this, under the bill the issuance of preferred stock is specifically prohibited. Therefore you cannot give them preferred stock; and if you offer them common stock, it runs directly counter to the idea of the bill that all common stock should have a preemptive feature.

As it is written—and I say this with due reservation, because Mr. Smith's discussion of that section indicated that it was not so intended, and I do not want to be unfair in that respect—the bill asks you to do something, in the case of the closed-end companies, which in one case is futile and in the other case is impossible.

I turn now, however, to the further portion of this bill which in my opinion is a completely indefensible confiscation of valuable rights. It is also in my opinion an unwarranted interference with management discretion.

Senator WAGNER. Before you go to that, may I ask you, Mr. Quinn, whether you have any doubts as to whether or not dividends should be limited by law to profits, and should not be permitted to be paid out of capital?

Mr. QUINN. Out of capital?

Senator WAGNER. Yes; dividends.

Mr. QUINN. Oh, out of capital surplus, do you mean?

Senator WAGNER. Yes.

Mr. QUINN. Well, Senator, I think that the question of governing dividends by Federal law is a very difficult one. In the first place,

you have State laws governing that. Most of these companies are incorporated under State laws. You have tax laws which define income in certain ways. If you now put in another provision regarding dividends, I think you get in a hopeless state of confusion.

Senator WAGNER. I do not know if that is so confusing. We had an instance here where—I have forgotten the amount—a rather large sum, $800,000, I think, was paid out of capital.

Mr. QUINN. Yes; but, Senator, if you recall that $800,000—and I think Judge Healey will agree with me—that was a misstatement of the income account, that permitted that. Because if you remember, Senator, he said that they manipulated things so that there was $800,000 more of income reported than actually should have been realized.

Senator WAGNER. Then you are not in favor of the payment of dividends out of the assets or out of capital or surplus or whatever you want to call it?

Mr. QUINN. Well, Senator, if you want me to go into a highly complicated discussion of the question of the payment of capital surplus and so forth, I should like to do it at a later time; because I think it is a complicated subject.

Senator WAGNER. It may be. I thought it was simple, but I do not know.

Mr. QUINN. It is not, sir.

Senator WAGNER. Well——

Mr. QUINN. I think, Senator, that really that question is so complicated that to attempt to legislate on it, you get really——

Senator WAGNER. How do you suppose the States have legislated on it?

Mr. QUINN. States have set down certain laws under which you are incorporated.

Senator WAGNER. Yes.

Mr. QUINN. You have been following those all the time; and your charter sets down certain requirements governing the declaration of dividends, and you follow those. The tax law sets down certain requirements on dividends.

Now, Senator, if following those you put in another, it seems to me a difficult proposition.

Senator WAGNER. Is it not a general proposition that dividends ought to be paid out of earnings?

Mr. QUINN. I do not think you can make that flat statement, sir.

Senator WAGNER. Well, I thought you could.

Senator HERRING. There is a distinction between dividends being paid out of capital, and being paid out of surplus, is there not?

Mr. QUINN. Yes, sir.

Senator WAGNER. I am talking about dividends being limited to earnings. That has a very definite meaning, it seems to me.

Senator HERRING. That is right.

Senator WAGNER. I thought that proposition was rather acceptable.

Senator HERRING. But might not surplus be earnings?

Senator WAGNER. That may be.

Mr. QUINN. Senator, under the tax law an investment company has to consider as earnings capital gains. That has nothing to do with interest and dividends. I mean that the tax law recognizes that there are other things than interest and dividends that have to be considered as income.

Senator WAGNER. Well, I am sorry to have interrupted you.

Mr. QUINN. That is all right. However, Senator, I should like to take up again that section of the bill which, as I said before, I think is a confiscation of valuable rights of shareholders, as well as an unwarranted interference with management discretion. I realize that that is a fairly strong statement, but I think I can prove that.

The proposed law provides that no dividend on junior securities may be paid by a management investment company having senior securities unless immediately after such payment any indebtedness of the company shall have an asset coverage of 300 percent, and any preferred stock shall have an asset coverage of 200 percent. That is bad enough, but that is not the worst part of it.

See what it does to existing contract rights: In all probability, outstanding bonds have indentures which provide the required coverage before dividends can be paid; and this might be 200 percent, 150 percent, or even a lesser percentage. You may have preferred-stock provisions in a charter which provide that junior dividends may be paid if the preferred stock has a coverage of less than 200 percent, which is the standard set down in this bill.

But all of these rights which have been agreed upon and accepted—and securities have been exchanged and securities have been purchased and bought—all are scrapped by this provision.

I think you will agree that, upon consideration, it is going pretty far thus to retroactively—and I want to stress that word—retroactively destroy existing contract rights, legally entered into and agreed upon by the people who were affected.

I should like to point out just how drastic and just how unworkable this provision is. I suppose it is designed to protect the senior security holder, by preventing the payment of dividends to junior security holders under circumstances that they do not think are proper. But let us take a possible case: Let's say that a company started out with $100,000,000 of assets. That $100,000,000 of assets is represented by $40,000,000 of bonds and $60,000,000 of common stock; that is the way they started, years ago. It would seem reasonable that if the charter provided that no dividends should be paid on the common stock unless this original ratio of contribution of capital was maintained, then that would be a reasonable provision.

This bill now comes along and says to the bondholders: "You made a very poor deal for yourselves, and we are going to come to your rescue. We are going to say that the common shareholders can no longer receive dividends, even though the company has kept all its funds, has not lost a penny, and has plenty of income not only to pay the bond interest but to pay a reasonable dividend on the common stock."

But this bill says:

> We shall not let you pay interest on the common stock until you have made at least $20,000,000.

That is what the law says; because it is only at that stage that the bonds will be covered 300 percent.

This sounds bad enough, but let me go on and point out how much farther this section goes. The coverage provided for debt is 300 percent. The coverage provided for preferred stock is 200 percent. If that were all, the stockholders could measure exactly just how badly their existing rights were being interfered with; they could measure

the exact amount which would be taken away from one class and given to another. But this section says that the Government agency can come along and change these percentages. It can make the coverage requirement on the debt as low as 200 percent or can raise it to 400 percent. It gives the Commission the power to say that the preferred stock need be covered only 150 percent or that it must be covered 300 percent. The law itself destroys rights; the S. E. C. is given the right to mitigate or increase that destruction. This is not merely by general rules and regulations, Senator; the Commission is given the authority to tell each individual company by specific order, addressed to that company alone, just when it can pay dividends.

What is the limitation on this authority? It is solely what, in their opinion, is desirable—and I quote—"for the protection of investors or to preserve the financial integrity of the company concerned."

Now, Senator, this bill contains one provision which I probably ought to leave to the lawyers to discuss; but I should like to say just one word. Section 17 (e) says:

> Any gross misconduct or gross abuse of trust in respect of a registered investment company * * * shall be unlawful.

Now, Senator, no one can quarrel with the general idea. Certainly, I have no word to say in favor of misconduct or abuse of trust, whether it is gross or petty; but I think you will sympathize with anyone's unwillingness to be subjected to a criminal penalty for violation of so indefinite and undefinable a prohibition.

I have only high-spotted certain portions of this bill which go too far afield from proper regulation. I do not want to take up your time with a number of other important portions which also need careful scrutiny.

I am coming to another section, Senator, and to a whole discussion of another group. So if you want to stop at this point for the recess, of course that is perfectly acceptable to me.

Senator WAGNER. Well, I want to confer with my colleagues here.

Mr. QUINN. I just mention that, Senator, to see if it is convenient for your to continue or to stop at this time.

Senator WAGNER. Would you gentlemen like to go on for half an hour longer or so?

Senator HERRING. It is all right with me.

Mr. QUINN. This is a rather long section, Senator, dealing with delegated powers.

Senator HUGHES. I should like to do it, but I really have made an engagement for 1 o'clock.

Senator WAGNER. Would you come back and be back at 2:30?

Senator HUGHES. I shall if I can.

Senator WAGNER. Can you come back at 2:30?

Senator HERRING. I think so.

Senator WAGNER. You will come back at 2:30?

Senator HUGHES. I will come back for a little while, but I may have to leave.

Senator WAGNER. All right. Then we shall recess at this time until 2:30.

(Thereupon, at 11:55 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTERNOON SESSION

The committee reconvened at 2:30 p. m., upon the expiration of the recess.

STATEMENT OF CYRIL J. C. QUINN—Resumed

Senator WAGNER. Now, Mr. Quinn, will you continue, please?

Mr. QUINN. Yes, sir.

I took up this morning those portions of the bill which I thought could be properly included in any regulatory bill. I made the reservation that I thought they needed considerable reworking. I also went on to point out certain things which I thought should not go in a regulatory bill.

I would now like to take up a rather important subject and to turn to a discussion of the broad and vague delegations of authority to the Commission in the proposed bill.

Senator WAGNER. In other words, you are going now to the discretionary features of the bill?

Mr. QUINN. That is right.

I want to point out at the start that I am not now discussing procedural matters but matters vitally affecting every investment company, which intimately touch day by day operations and which directly concern the security holders. To my mind some of the most dangerous portions of this bill are contained in those sections which I will now discuss.

In this connection I recall a few of the comments of Judge Healy when he addressed you gentlemen in his opening remarks. He stated that to him the greatest virtue of administrative processes is flexibility. I do not dispute this. I agree that within limits flexibility is desirable, but I must remind you gentlemen that reasonable flexibility in the administrative processes is one thing and broad delegation of powers is quite another.

Judge Healy speaks of the false idea that the rule-making power is the power to make laws. He says that the Commission does not have this power; that no one has the power to make laws except Congress. I am not a lawyer and I accept this statement of Judge Healy. But, gentlemen, it makes no difference to me whether I am sent to jail for 2 years for violating a law enacted by Congress or whether I am sent to jail for the same period of 2 years for violating a rule or regulation promulgated by the S. E. C. Whether they are called rules and regulations or laws makes no difference to me. I feel that I have a right to demand as an American citizen that these mandates be the mandates of the duly elected representatives of the Congress. Flexibility, yes. I appreciate that that is necessary. But the fundamental dictates that are to govern me and my industry should come from the Congress and not from any governmental agency.

At this point I would like to say that I wonder if some of you gentlemen have ever looked carefully at a rule of the S. E. C. I would like to show you one, which is the present rule covering the solicitation of proxies, consents, and authorizations. That is the rule which I said, with regard to the companies I represent, is already

in force, because they are listed on national security exchanges. That rule is identified as Rule X–14A–1, and there are six pages of rules and a schedule, 14A.

The reason I bring that up is that there is so much talk of rules and regulations and there is so much mention of that through this bill that I wanted to show you gentlemen just what we are talking about when we talk about rules and regulations.

Now, the plain fact of the matter is, gentlemen, that you and we have been given only half a bill. The other half is left to future rules, regulations, and orders of a Government commission.

Senator WAGNER. Well, do I understand——

Mr. QUINN. I want to go on, Senator.

Senator WAGNER. All right.

Mr. QUINN. I am not talking loosely. If anything, I am understating the case.

There are 83 delegations of power to the S. E. C. in the 81 provisions of title I, exclusive of the preamble and general definitions.

Someone with a perverted sense of humor has even counted how many times the bill mentions the words "investment company" and how many times the word "Commission" recurs. They tell me that in this bill to regulate investment companies the words "investment company" occur 135 times and the word "Commission" occurs 141 times.

I don't argue that all of these delegations are unnecessary or all of equal importance. Some of them must be in an act of this sort to give necessary elasticity.

But I have analyzed them carefully and I find that there are 35 delegations of power which are of real importance, 13 covering accounting and reports, and 22 covering other important questions of general policy and detailed operation of investment companies. These 35 delegations do not include 12 giving the right to grant exemptions, in most cases without any guiding rules or standards and with complete freedom in most if not all cases, to favor one company or discriminate against another. I do not say the S. E. C. would do that—but the power is there.

Let me go at it another way. As I analyze the bill, it deals with 30 different separate subjects. Of these 30 subjects only 8 are covered by definite, specific provisions; five are covered by specific provisions, but the S. E. C. can grant exceptions, in most cases without any limitation whatever on their discretion; 10 are covered partly in the bill, but the powers reserved to the S. E. C. further to define, alter, and rule are so vital that in many of these important matters no one will know where one stands until the Commission issues its rules, regulations and orders; 7 are covered by virtually blanket delegations of power to the S. E. C.

I think you will agree that my statement that you are considering only half a bill is really no exaggeration.

I would like to make this clear, and I hope neither you gentlemen nor the Commission will interpret what I have to say regarding delegation of powers as an attack on the S. E. C. It is neither so intended nor so designed. The objections which I will present are no reflection on that body. The arguments I will make can with equal force be applied to any Government agency. My only present question regarding the S. E. C. is how they are going to have any time to devote

to regulating the daily life of this business. They have to administer the Securities Act of 1933, the Securities and Exchange Act of 1934, the Public Utility Holding Company Act, the Chandler bankruptcy bill, the Barkley Trust Indenture Act, and the Maloney Over-the-Counter Act. How five men can humanly cope with that gigantic administrative job is more than I can understand.

I am not interested in attacking the S. E. C. but I am interested in trying to the best of my ability to make you gentlemen see that a business to be regulated has a right to ask that the law governing that business be clear, explicit, and understandable, and that you can't expect a business to function or a management to do a good job if a good part of the management's time and effort is spent in trying to guess not only what a law means but in following the daily flow of rules, regulations, and orders which can come out of these delegated powers.

In connection with these important delegations of power, I would like to make four points:

First. Many of them are blank checks of power which it is proposed that you gentlemen shall sign and hand over to a Government agency with little or no limitation on their use.

Two. They give the commission not only the right to make rules and regulations but in most instances they also give the right to the commission to make orders which may compel one company to do one thing and compel another company to do another. As a general policy I think this is open to serious question, as it opens the way for possible favoritism or discrimination.

Many of these provisions are molded on provisions in other acts, notably the Public Utility Holding Company Act. That was referred to several times in the testimony of previous days. In fact, in taking over one of the sections from that act the word "consumer" has lost its way into this bill. But I say in all seriousness that in my opinion, in the aggregate, they go wider and deeper than in any previous act.

Whether or not they were necessary in a previous act is not a matter for present discussion but I do think that the argument that they were necessary there is no argument for their inclusion here. Powers that may have been necessary and defensible in a particular industry and in a particular bill should not now be enshrined as established precedents for this and all other businesses. Just think back a short time and remember how extreme and novel those powers were considered at that time. Then let me recall Mr. Schenker's characterization of them in these hearings as "boiler-plate."

With your permission I would like to go into some detail regarding certain of the powers reserved to the Commission in this bill. Unless this is done I do not think you gentlemen will realize how sweeping are some of the powers given them and how wide is the discretion left to that body.

I talked this morning about the discretion left to them in connection with the question of dividends, and I think that it was very clear there that it went beyond a reasonable length in giving discretion over so important a subject.

I would like to refer now to section 18, dealing with capital structure. This contains that remarkable provision giving the Commission power after 2 years to require by specific order that every regis-

tered investment company take such steps as are necessary and appropriate to effect an equitable redistribution of voting rights and privileges among the holders of the outstanding securities of such company or companies.

The language is ambiguous and one cannot be quite certain whether this power applies only to investment company systems or as well to investment companies which form no part of a system, but I am advised that it probably includes the latter as well. Mr. Schenker in his testimony confirmed this opinion. Mind you, this is not a matter to be covered by general rules and regulations, but by specific order addressed to the individual company. That means that the S. E. C. is given the power in its discretion to decide with respect to each company what it considers to be an equitable distribution of voting rights and privileges.

How this is to be accomplished I do not know. I am not a lawyer. I say this with some diffidence because all the people who have appeared for the other side are lawyers. But I have had sufficient experience with corporate affairs to know that voting rights are determined either by the law of the State of incorporation or by the certificate of incorporation. I know that such changes as are envisaged can be made only by the vote of the stockholders themselves. The corporation as such obviously has no power, but the act reads:

> Shall require by order every registered investment company take such steps as are necessary.

It is a matter of contractual rights as between the various classes of stockholders.

Senator HUGHES. Excuse me, Mr. Quinn. Will you let me ask a question?

Mr. QUINN. Yes.

Senator HUGHES. Doesn't that mean such steps as are necessary to require them to amend their charter?

Mr. QUINN. But the charter can only be amended by the vote of the shareholders, Senator.

Senator HUGHES. But they can take the steps that are necessary to do that?

Mr. QUINN. They can put the question to the shareholders, and it is for the shareholders to decide.

Senator DOWNEY. Let me interpose a statement. It says that the move to change the voting power must be instituted by the stockholders; it cannot be done by the directors.

Senator HUGHES. The stockholders would have to move to call a meeting of the directors to consider a change in their voting powers and the stockholders at the meeting could take that up. That is the usual rule. That is the way I understand it.

Mr. QUINN. Shall I proceed, Senator?

Senator WAGNER. Yes.

Mr. QUINN. Is the S. E. C. to be given the necessary jurisdiction to make each stockholder vote in favor of a redistribution of voting rights to accord with the judgment of the Commission as to what is equitable for that corporation? If so, is it to have the authority to do it once or will they come back every time that a rise or fall in market values shall have so affected the relative asset values of the various classes of securities as to make their previous decision of what was equitable no longer tenable? Is the Commission to have the authority

to give voting rights to bonds and debentures and, if so, will it have the further jurisdiction over members of State legislatures to compel such changes in State law as may be necessary to make this possible?

But aside from the question of difficulty of enforcement, and this is no mere technicality, it may serve well to illustrate the radical nature of the proposal. I do not suppose that I have to point out to you gentlemen what an extreme interference this is with existing contract rights of security holders. I have heard Mr. Schenker say that he will present a separate memorandum on the constitutionality of this provision. As I said, I'm not a lawyer. I don't know what is constitutional or what is not but I feel confident that the Congress will not wantonly destroy existing contract rights of real value.

I understand that proponents of the bill feel that it is not fair and equitable that in many instances holders of common stock, whose asset value has drastically shrunk, should now have voting power out of proportion to the underlying value of their security in relation to the senior security. But have they considered that the reason that in the main the asset value of this common stock which they now wish to disenfranchise has drastically shrunk while the liquidating value of say the preferred stock remains at par is because this common stock has by contract with the preferred stockholders placed their money behind the contribution of the preferred stockholders as a cushion to the investment of the preferred stock? As a part of this contract and as a part of the consideration for their placing their funds behind the contribution of the preferred stockholder they have received certain contract rights. Is it fair now to say that because their asset value has shrunk while the asset value of the preferred stock has remained intact, due to this contractual arrangement, the common stockholder shall now be deprived of his contractual voting rights?

If this radical idea is sound, why confine it to investment companies. Why not legislate that when an industrial company operates at a deficit all voting power should be taken away from the common stock and given to the bondholders.

Apart from the question of interference with the contract rights of stockholders, can anyone imagine a broader and more unlimited delegation of power than that given to the Commission in this respect to—I am now quoting—"take such steps as are necessary or appropriate to effect an equitable redistribution of voting rights and privileges"? There are no standards and there are no guides for action. This vitally important matter is left to the unlimited discretion of the Commission.

Section 25 gives the Commission the right to veto any plan of reorganization, voluntary dissolution, or liquidation of certain investment companies or any plan of reorganization or restatement of capital of any investment company. This is apparently modeled on the Chandler Act which gives the S. E. C., under the bankruptcy power, certain rights to render advisory opinions in the reorganization of insolvent companies under court jurisdiction.

But this proposed legislation goes leagues beyond that. It gives the Commission greater rights over solvent companies than they now have over insolvent companies. They can veto any plan of reorganization or recapitalization. Regardless of the shareholders opinions in the matter, the right of their deciding is taken away from them and vested in a Government bureau. They can only do what they want with the blessing of the Commission.

And the only curb on this power is that the Commission must find a plan "not equitable and fair to all classes and persons affected." No standards of equity and fairness are stated. They are left to the sole discretion of a Government bureau.

This provision goes even further. Under the Chandler Act the Commission is authorized to give advisory opinions to the court which has the company under its protection. The provision in this act sets the S. E. C. above the courts. I refer to the provision that no one is permitted to present a plan of reorganization to a United States court without the previous approval of the S. E. C. I refer further to the provision that no United States court can approve a plan until it has received the approval of the S. E. C.

The discussion of this provision in the committee has been enlightening. Senator Herring suggested the possibility that the powers of the S. E. C. over the reorganization of companies in bankruptcy or receivership be limited to powers similar to those given the S. E. C. under the Chander Act—Is that correct, Senator?

Senator Herring. That is right.

Mr. Quinn. And that the S. E. C. be given the right only to render an advisory opinion upon the court's request. Judge Healy agreed that this might be the proper limitation. But in the case of the mergers, consolidations, or recapitalizations of solvent companies Judge Healy said that that was not enough. His argument, as I interpret it, is this. Plans of recapitalization and reorganization are sometimes complicated and difficult to understand. He did not make clear that under the proxy regulations embodied in this bill the S. E. C. can go practically the limit to see that both sides of the question are presented with complete fairness, impartiality, and clarity. The proxy regulations give the Commission the power to see that the shareholder is given all the information that can reasonably be required for him to make up his own mind.

But at this point we come to the kernel of Judge Healy's argument and we come to what in my opinion is one of the most glaring faults in the philosophy underlying certain portions of this bill. The S. E. C. is not willing to let the shareholders decide what they want to do. They are not willing to limit themselves to seeing that the stockholders get all the information necessary for them to make up their mind. The S. E. C. wants to decide for the shareholders because they think they are apparently neither able nor competent to decide for themselves. I think that is a fair interpretation of what Judge Healy said.

How else can you explain the insistence of the S. E. C. that a voluntary plan of a solvent company for readjusting its capital structure shall be subjected to their approval before the stockholders have a right to say what they want to do?

Senator Hughes. I might say that I am not sure but what he is right about that. I doubt if they are competent to decide about these complicated matters. Going back to what you said a minute ago about the court having the jurisdiction, I cannot go quite that far.

Mr. Quinn. I am not talking about companies under the court; I am talking about solvent companies making voluntary plans of readjustment of their own, outside the court.

Mr. Schenker in his comment made one further illuminating statement. He said sometimes the majority wish to do something which

might be bad for the minority. What sort of a new doctrine is this that a Government agency is going to decide all questions for shareholders? Is the democratic rule of the majority no longer to hold, but must we all come down to a Government agency to find out what can and what cannot be done, regardless of existing laws, regardless of existing rights, and regardless of the wishes of those concerned?

Anything approaching this, in my opinion, gentlemen, is not regulation. It goes much further than that.

Section 33 (a) contains not only a legal novelty but a prohibition on the United States courts from acting on matters within their jurisdiction without prior consultation with the S. E. C. This section prohibits any officer or director from settling any threatened suit for an alleged breach of official duty. This provision is patently a trial venture in uncharted legal seas. It adds a further novelty in that it prohibits any United States court from approving the fairness of the proposed settlement until after the Commission has filed a report concerning the fairness of the plan. I am not a lawyer and I am not competent to judge, but it does seem to me to make common sense that if the S. E. C. proposes to invent new Federal legal procedure or reform existing legal procedure, it ought to hand that job over to the proper department. It ought not to stick such a provision in this bill. If the idea has any merit, which I honestly doubt, it should apply not only to investment companies but to all companies in all businesses. It has no place in this bill.

Section 13 (b) provides that no registered investment company shall change any fundamental investment or management policy unless each change is authorized by shareholders. As a general statement, this is not open to criticism. It expresses the agreed principle that shareholders should be consulted in regard to any radical change in policy on the part of their management. But the Commission is given the right by rules and regulations to designate what investment policies are fundamental. It can by order say what policies are fundamental to each particular company. Is this not overregulation and does it not go beyond the bounds of sound legislation? Can't this desirable objective be achieved in some other way?

Senator WAGNER. Have you any ideas?

Mr. QUINN. I have an idea, Senator.

Senator WAGNER. You are going to suggest it, are you?

Mr. QUINN. This is going to be discussed in somewhat fuller length somewhat later on.

Senator WAGNER. All right; because I am interested in that question, too.

Mr. QUINN. I think there is an easier way to solve it. Section 9 (c) is part of that section which requires registration with the Commission of officers and directors of investment companies. The registration of investment companies themselves may well be desirable if only to bring all companies within certain rules which now apply to those companies listed on national security exchanges. But I question greatly the wisdom of requiring the directors of investment companies to register. This is a requirement which applies to the directors of no other form of American business. Bank directors are not required to register; insurance company directors are not required to register. But this provision not only requires the registration of

directors of investment companies but gives a Government bureau the right to dictate without limitation the type of information, business and personal, which the directors must file with it and which it has the right to make available to the public.

Now, I recall Judge Healy's discussion on that point, and I feel that the Commission would probably limit that; but what I am talking about is the law as written. This is what the law permits them to do.

Section 17 (g), part of that same thing, goes one step further. This section gives the Commission the right to require by specific order directed to an individual director of an individual company that that director must be bonded and in such amount as the Commission may fix. I have never heard of bonding directors who are not officers. I have certainly never heard of such a provision in any law.

These are a few samples. I think you will agree that they contain, as far as we are concerned, a good deal more than elastic.

You may rightly say, "You have been very critical but what would you suggest be done in regard to this delegation of power. Certainly some of them are necessary. How would you go about remedying what you consider excessive grants of power?" If you ask me, I would say that I would send the bill back where it came from for a complete overhauling with the following instructions:

If the men who drafted the bill in regard to certain matters have been unable after 4 years to make up their minds what should be done and have reserved the right for the Commission to make up its mind later on, it is pretty certain that those are not proper matters for legislation and should be scrapped immediately.

If they have made up their minds and have not wanted to put their decision in the bill because it would sound too dictatorial and too strong tell them not to hide behind the curtain of future rules, regulations, and orders but to spell it out so you can see what they have in their minds.

If they think it is necessary to provide a certain flexibility in certain rigid requirements of the bill, tell them to be sure that there is not (*a*) power left to increase the rigidity and (*b*) there is no power left to require one company to do anything which is not required of all investment companies generally.

In dealing with exemptions, tell them not to leave sole and complete discretion to the Commission. Tell them to set down certain standards to guide the Commission and those who may wish to apply to the Commission for exemptions.

This is, I think, Senator, extremely important: Ask them to expressly provide for some sort of official consultation with duly constituted representatives of the industry before any rules or regulations can be promulgated by the Commission on any subject.

I have not touched one important part of the bill, those sections which deal with reports to shareholders and accounts of the companies. With the general principle that shareholders should be furnished periodically with complete detailed information of the status and operations of their company no one has any quarrel whatever. In fact most of the better known investment companies do a first class job in this respect.

Before discussing the way this acceptable principle is worked out in this bill I would like to make a comment in regard to the general

subject of accounts and reports of investment companies because I think it will help to clarify the discussion.

In the first place, unlike the railroad business and the public utility business in which the Government has prescribed rather stringent rules on how accounts should be kept and reports made, the investment company accounts and reports have no purpose other than informing the shareholder. Judge Healy kept referring constantly to the utility business as a precedent. But in the utility and railroad business there is another consideration which must be weighed and which justifies rather stringent and exact rules on how accounts should be kept. In the railroads the rate-making aspect enters and in the public-utility business this consideration is also present. This is an important distinction.

The second point I would like to make is that a proper report of an investment company is the clearest and most understandable of any form of business report. Let me try to explain why this is true.

Look at the balance sheet of an investment company and you will see on the asset side cash items, the amount of investments and their value at the time of the report. You have thus a clear and concise statement of what the assets are worth at the time of the report. If you will turn to the supplementary information furnished in most reports, you will find a complete list of all securities held together with their individual market values. If there is no market value there is a statement on the basis on which the valuation has been arrived at.

If you turn to the auditor's report you will usually find a statement that the auditors have not only verified all accounts but have inspected and counted all securities owned by the corporation at the date of the report and found them to be in agreement with the books of the corporation and with the securities as listed in the report.

You thus have the cleanest, clearest picture of the assets of the corporation and their value which one could ask.

On the liability side current liabilities are shown and various other items of debt if it exists, capital stock, and surplus.

In many reports you not only have this clear-cut balance sheet but you have a statement summarizing assets and liabilities and showing the asset coverage of each type of security outstanding as of the date of the report.

The statement of an investment company is thus the easiest statement of any type of business to understand. In a bank statement no shareholder or depositor is given any information on which he can appraise the extent of the risk involved in the loans that have been made, or is given detailed information of the securities owned.

In an insurance company no stockholder or policyholder has any way of appraising the amount or quality of the underwriting risks.

In a manufacturing company no stockholder has any idea of what his plant may be worth if it had to be disposed of. He does not know the details of inventory; patent rights may be important or not; and there are a thousand and one elements which make it difficult for him to appraise the value of the assets of his company. The investment company stockholder is under no such handicap.

If you turn to the income account of most investment companies you will see the income set forth, together with the sources from which it is derived, and you find the expenses set down in pretty considerable detail.

If you turn to other pages of most annual reports you will find a statement of the commissions paid by the corporation in connection with its purchase and sale of securities, and if they have been paid to any people connected with the corporation, a statement of the amount paid to each such person. You will also find other pertinent information so that the shareholder has a pretty complete picture of how his company stands at the time of the report and what has happened to it in the interval since the last report.

It would seem, therefore, reasonable that these practices of accounting and reporting which are common to most of the well-run companies could be embodied in the provisions of this bill in general terms.

But what do you find instead—a complete blank check to the Commission. There is no single standard to guide them or to restrict them. Let me show you the extent of the powers given them.

Senator HUGHES. Might I interrupt you a minute?

Mr. QUINN. I beg your pardon?

Senator HUGHES. Might I interrupt you a minute?

Mr. QUINN. Yes.

Senator HUGHES. Would it be feasible for you to furnish the committee with your last report?

Mr. QUINN. Yes, sir; I will be glad to.

Senator HUGHES. I do not know whether you want to make it part of the record.

Mr. QUINN. I will be glad to show it to you.

Senator WAGNER. Have you it here?

Mr. QUINN. I do not know whether the last annual report is here or not. I will be glad to get it.

Senator WAGNER. And we will put it in the record.

Mr. QUINN. All right, sir.

First, let me deal with accounts. Section 31 (d) gives the Commission the right to make rules and regulations for uniform methods for keeping accounts and other records and for prescribing methods, practices, and procedure to be followed in determining entries to be made.

It goes further. It gives the Commission the power to prescribe by order the account or accounts in which particular outlays, receipts, expenses, income, profits, losses, depreciation, appreciation, dividend distributions, and other transactions shall be entered, charged, or credited and the manner in which any such entry, charge, or credit shall be made.

It goes even further.

Senator WAGNER. Is there any objection to that? Do you object to that?

Mr. QUINN. We object to that seriously, sir. It goes even further. It gives the Commission the right to prohibit the keeping of accounting methods other than those prescribed by the Commission and the keeping of such records in a manner other than that prescribed and approved by the Commission.

You were told that this was not as rigid as it sounds, that there was an exception permitting the keeping of other accounts. But examine this exception carefully and you will find that it only permits subclassification of accounts. The S. E. C. has the absolute power to order each individual company to make such general entries on its

books as the S. E. C. sees fit. Judge Healy talked about the desirability and difficulty of legislating uniform accounting methods. I quite agree with him but I don't think the method of working it out is to give the Commission the power to order a company to keep its books in one particular way and no other way.

Accounting is not an exact science although there is a good deal of fuzzy thinking which arrives at that conclusion. You can find differences of opinion between the best accountants and the best-intentioned managements as to how a particular account should be kept. Outside of certain general rules specifying the type of information which should be furnished shareholders, and which can very well be embodied in this act, there is another field on which there is room for difference of opinion and which should be left to the managements to set out in the way they think is proper and fair. Certainly no legislation should force managements to keep their accounts in a way which they may honestly feel to be wrong and not only force them to do this but prohibit them from keeping them in any other way.

As you gentlemen know, some investment companies keep a set of books which are different from the corporate books for very obvious reasons. They may treat securities for tax purposes as first in, first out, or they may treat them on a specific certificate basis. These practices are recognized as entirely proper by the tax authorities. Does this section mean that the whole tax treatment, historic and otherwise, of the company may be upset with possibilities of grave difficulties and expense to the security holders? As I analyze the bill as written, it would permit it.

My suggestion for dealing with this matter of accounts is not to force all the treasurers or comptrollers out of a job by leaving everything but the actual bookkeeping to the Commission but to set down in this act certain general and already well-known standards which all companies must follow. Provide the elastic in the way that Judge Healy has suggested, that in consultation with the companies interested and the best-known and most competent accountants, the Commission work out a method of handling the debatable items of accounting in a way which seems reasonable, but handle this complicated matter outside the law.

This section also deals with accountants and auditors, and on this question Mr. McGrath will speak to you more fully for this group.

Senator Hughes. If it is outside the law, you could not be required to do it.

Mr. Quinn. If you take the standards which are fairly well known of what items should be shown in reasonable detail, you will cover all except the debatable items where there may be differences of opinion.

I would like now to pass to the question of reports——

Senator Wagner. Before you pass on to another subject, do you think there ought to be any kind of regulation with reference to the bookkeeping? Do you think there ought to be any fixed statute on the subject?

Mr. Quinn. If the statute contained certain definite standards of reports required of companies, we would not object to that. But when you get down to the specific details of how actual accounts shall be handled, there are honest differences of opinion as to how many of these entries ought to be made. Don't put it so that you would get 2 years in jail if you violated a rule. I think that is going much too

far. I think you will find that if the Commission worked out with the industry and the accountants uniform methods of handling those debatable items, it is not necessary to go into the law. I do not think it is important enough, Senator, because the main, important items you can follow definite standards on. I know Judge Healy will not agree with me, but that is my view.

Senator WAGNER. I was just going to ask you this further question, because I know I speak the sentiment of every member of this committee and, I take it from what has been said, of Judge Healy, that there ought not to be any delegation of discretionary power wherever it can be fixed by law; that is, provided regulation is desirable. Whereever possible it ought to be fixed by law rather than giving anybody particular discretionary power. So that I know that as far as possible this committee will reduce to an absolute minimum any discretionary power that may be delegated, and then of course always under certain fixed standards. But where there is authority to prescribe a rule, should there not be some method of enforcing that rule when there is a violation of it?

Mr. QUINN. Oh, yes. Where there is a rule that applies to a specific section, implementing that section, that naturally becomes part of the act. But where there are rules applying to these debatable methods——

Senator WAGNER. I think you misunderstood me. We are all agreed that where discretionary power is needed the Commission should be authorized to make a rule. There ought to be some provision in the law for the enforcement of that rule.

Mr. QUINN. Yes, sir; we agree with that.

Senator WAGNER. So that there ought to be some penalty prescribed. As I understand your statement, you think that the penalty prescribed is too drastic?

Mr. QUINN. I say that the penalty prescribed goes to matters which are not clear and explicit and which are in many cases dealing with subjects which should not be in this law at all.

Senator WAGNER. That is another thing. We do not understand one another. I agree with you that wherever there is even doubt as to whether there should be rules there ought not to be a delegation of discretionary power. Wherever possible it ought to be fixed in the law. I think everybody agrees to that. But accordinging to your testimony there are some instances where, under proper standards, delegation may be proper; that is, it may be proper to delegate the power to make rules.

Mr. QUINN. If there are necessary standards.

Senator WAGNER. I am assuming that. We have agreed that there is a certain discretionary power that is needed in a particular case, which means that a rule is prescribed. That, then, has the effect of a statute, and there ought to be some penalty provided for a violation of that rule. It may not be as great a penalty as is prescribed here; but you agree that there ought to be some method of enforcing it?

Mr. QUINN. Yes. The other safeguard that I suggested in regard to making those rules and regulations is that prior to their promulgation there should be some consultation.

Senator WAGNER. Yes; that rather appeals to me. You mean, that there ought to be a hearing of some kind?

Mr. QUINN. Not necessarily a hearing.

Senator WAGNER. Of course I want to hear the other side on these matters; but that sounds reasonable to me, that there certainly ought

to be a hearing before a rule is promulgated by the Commission affecting a certain industry.

Mr. QUINN. The S. E. C. has consulted many people.

Mr. HEALY. We have consulted a great many people.

Mr. QUINN. I think it ought to be provided that that be done.

Mr. HEALY. You are not suggesting a hearing; you are suggesting that a consultation be provided for?

Mr. QUINN. Some appropriate official form of consultation.

Senator WAGNER. Is there objection to a hearing?

Mr. HEALY. I do not think the industry likes the hearing idea.

Senator WAGNER. In most of our agencies where there is authority to make rules, there is also a provision for a hearing before the rule is adopted, is there not?

Mr. QUINN. No, sir.

Senator WAGNER. That will come up later on, anyway.

Mr. HEALY. Our practice has been—we have not followed it in every instance, but, generally speaking, we have enacted very few rules of any consequence, without consultation with the people concerned. If I might interrupt, I think it might be wise in that connection to say that I think you ought to have some provision for an emergency case.

Senator HERRING. There has been quite a little evidence from one side and the other as to the opportunity for conferences with the industry in the preparation of this bill, over the past 2 or 3 or 4 years. Has your organization been consulted or offered an opportunity to discuss this measure?

Mr. QUINN. Yes, sir.

Senator HERRING. It has been?

Mr. QUINN. I want to explain, Senator Herring, just what was involved in that consultation. We worked originally with the S. E. C. on the preparation of the questionnaire. I think that consultation consumed about 6 weeks, getting that questionnaire in a form which everybody thought was satisfactory. We worked for a long time getting that questionnaire filled out. I think our answer weighed 52 pounds. Then from time to time we have talked to the staff of the S. E. C. and to Judge Healy in connection with this; and it was our understanding that before this bill was introduced we would have an opportunity to sit down and discuss it in detail. I am not sure that I have the dates right, but about the end of February we came down and Mr. Schenker went over with us the general provisions of a bill. That was not in detail; that was just a general outline. That was on Friday. They asked us if we could come back on Tuesday and talk to the Commission Tuesday afternoon. We went back on Tuesday afternoon and talked to, I think, four out of five members of the Commission. We naturally confined ourselves to some of the important items, because, after all, one afternoon did not give an opportunity to cover them all, and we did not know what the bill said.

Then we were asked if we would not talk to the staff again, which we did on the following Friday and on Saturday morning, and we went back and talked with the Commission on Tuesday. We presented and reiterated—because the chairman had not been present at the first session, and was present at that session—our objections to certain fundamental principles of this bill. We could not talk about the language; we did not have it. We were talking about principles.

When we got through—they were extremely courteous and considerate in the hearing—they said:

> Now, gentlemen, thank you very much. We cannot listen to you any more, because we have got to go on with other groups that have to be consulted.

And then the next we knew about the bill was when it was presented. That, I think, is a fair statement.

Senator WAGNER. I do not know what your experience has been, and maybe this is not the place for me to state it: At the end of last session Judge Healy discussed with me, as chairman of the Banking and Currency Committee, the fact that they had concluded their study and were preparing some legislation—which he said would be ready for the next session—but that they intended to take all the intervening time to discuss the matter with the industry in the hope of agreeing upon legislation satisfactory to all sides. Of course there is always a certain question of enforcement that is always difficult to agree upon. But that was away back in the last session. That was a long while ago. I do not think there is any justification for postponing consideration of that question. There may be changes that we would want to make, but I think the matter is before us now.

Am I correct in that statement, Judge Healy, as to the discussion last year?

Mr. HEALY. We had a discussion, and the statement was made concerning the preparation of a bill. I did not say that the study was finished completely.

Senator WAGNER. That is true; you did not.

Mr. HEALY. All through the hearings, as you will see by consulting the record, when various representatives of the industry were examined by Mr. Schenker, they were not only asked about the facts of their particular companies but they were asked to give their ideas on the subject of legislation. The chairman of Mr. Quinn's company filed with us in July 1937 a printed memorandum of recommendations which we discussed with him and we talked over the matter ourselves, and there were a number of other memoranda.

When we got down to the point of recommendation we discussed the recommendations and, furthermore, in addition to the two conferences that we had with Mr. Quinn's group of course we had to spend considerable time in other groups. I made the statement then—and I think Mr. Quinn will agree that this is so—that at that time we could not go into precise language; that when the bill was printed, after it was introduced and before it came to hearings, we would be delighted to sit down with the industry and discuss it paragraph by paragraph.

When the bill was introduced I asked one or two of the newspapermen to state for the newspapers that we would consult with the industry; and Mr. Schenker also communicated with some of them. I do not know which ones.

I really do not see how we could have been more considerate.

Mr. QUINN. Senator, Judge Healy has always been extremely considerate. But I would like to make this point in regard to that criticism of our not talking with them regarding the specific provisions of the bill between the time it was introduced and the time we were to appear here. We had never seen the language of the bill up to the time it was introduced. You have read the bill. You know how difficult it is to understand. We were here trying to get ready to

present our views of the bill at this hearing. Certainly there was no opportunity, except possibly from 2 to 3 every morning, to sit down and discuss the details of this bill with the Commission. We had our hands full.

The other point that I would like to make, Senator, is this: That I do not see what useful purpose a discussion of the language of the bill would have served with the Commission at that time. They had made up their minds what they thought was right. We had already expressed our wholesale objections to certain provisions of the bill. We got nowhere. The bill contains those provisions still.

I think that it is unreasonable of Judge Healy to expect us, in the midst of preparing for a hearing, to go and discuss language to achieve objects with which we did not agree.

Senator WAGNER. You have mastered the bill. I can see that from your memorandum.

Mr. SCHENKER. May I say a word, Mr. Chairman?

Senator WAGNER. Yes.

Mr. SCHENKER. All I would like to say is this. I think the record ought to indicate the scope of my discussion of the provisions of the bill with the industry; and I think the best indication of that would be if Mr. Bunker would produce the memorandum that he prepared when he got back to New York, a copy of which he said he would give to anybody in the industry, as to what the contemplated recommendations are. That would give you some indication of the extent to which and the details of which we discussed the matter with the industry, and, I think, would also give you the extent to which the Commission met the objections of the industry, and to what extent the bill as submitted to the committee conforms to our original ideas before we discussed it with those representing the industry. So that if Mr. Bunker can produce that memorandum, I think it will give some idea of the details of the provisions we discussed and even the language of the bill.

Mr. BUNKER. If I may say so, Senator, I shall be delighted to produce the memorardum of the outline of the bill, which is as complete as it was possible for all of us collectively to make it after having had our conferences.

I think in that connection it is only fair to say that I naturally have not got the document with me, because we have gone to a much more particularized bill. The industry found that its hands were extraordinarily full when it looked at a 104-page bill compared with a 2½-page memorandum. The transition between a general outline of 2½ pages or 3 pages and a 104-page bill is simply enormous. It presented us with hundreds of problems, not anticipating, Senator Wagner, that that difficulty would arise; and on the 1st of January I had seen a great many notices in the press that the S. E. C. was about to bring out this bill. The same rumors existed a year ago. Therefore I wrote to the Commission and said that our little group wished to cooperate, but I did not think it could do so unless we could see all the particularizations of the bill; that it had taken us 6 weeks in order to prepare the questionnaire, and that if it was a matter of 2 or 3 days we could not bring forth anything which would be helpful toward the development of a bill.

I do not know whether it was thought inappropriate or whether the bill was not ready, but, as Mr. Quinn has said, we could not get at the working basis of that bill.

I have enjoyed, and I think Mr. Quinn and all the members of our group have enjoyed, a very close cooperative feeling and respect for the members of the Commission; but as a pure matter of workmanship I cannot say that we were placed in a position to discharge a good workmanlike job.

I would be glad to file that letter, which I wrote early in January, requesting both cooperation and workmanship.

Mr. QUINN. Senator, you were kind enough to say that you thought I had a working knowledge of the bill. I can assure you that that is the result of a fair amount of work during the last 3 weeks.

Senator WAGNER. We all do our best work under pressure, you know.

Mr. QUINN. I would like to pass now to the question of reports required under section 30. At the risk of boring you, I wish to repeat my statement that no one quarrels with the idea of keeping investors fully and periodically informed. I would think that if this section provided that each company must provide its shareholders with quarterly reports in the form that I have previously described perhaps it would have done all that it is necessary to do to insure such information reaching the stockholders of all companies.

Let us examine, however, paragraph (c) of section 30 and see how far this section really goes. It reads:

> The Commission shall require by rules, regulations, or order, if and to the extent that the Commission finds such action necessary or appropriate in the public interest or for the protection of public investors, that a registered investment company transmit periodic and special reports or notices to the security holders or specified classes of the security holders of such company, at such time and in such form and detail as the Commission shall prescribe.

The discussion indicated that these reports are limited to accounts and reports filed as part of the registration statement and periodic reports filed under the act, to keep that registration statement up to date.

As I read the act, that limitation doesn't hold. It extends to all other documents filed under this title; and that includes a host of things, including even the minutes of directors' meetings.

Isn't this going pretty far? Doesn't it empower the Commission—I do not say that they will, but I am talking about what the law says—not only to say that a company must send a report to all its shareholders or certain classes upon any subject at any time, but that it must do it in such form and detail as the Commission shall prescribe? Is this not really an unwarrantable interference with management? Does it not permit an unreasonable burden of trouble and expense?

Will not the suggestions I have made really provide the shareholders with all the information they could want or assimilate?

Let us go one step further in the powers given to the Commission. Section 31 (a) says that the company shall make, keep, and preserve for such periods as the Commission may prescribe, such accounts, cost-accounting procedures—and that is evidently a carry-over from the Public Utility Act, because I have never heard of it in an investment company—correspondence, memoranda, papers, books, and other records as the Commission may prescribe. This is not limited to making rules and regulations applicable to all companies but the Commission may order specific companies to keep specific records.

The next section gives the Commission the right to inspect these records from time to time. This is along the lines of the examination

similar to a bank examination which has been suggested here as perhaps an appropriate accompaniment of this legislation.

But paragraph (c) goes way beyond that. Let me read it:

> The Commission or any member or representative thereof designated by it shall have power at any time and from time to time to make an examination of all the affairs of any registered investment company.

No restrictions, no subpenas, no limitation whatever on this arbitrary power to go into investment policy or any other matter they may care to.

I submit to you, gentlemen, that this is a far cry from the reiterated statement of the S. E. C. in these hearings that it is desirable to have a little bit of elastic.

And let me conclude with one other section, section 34: "It shall be unlawful for any persons except as permitted by rule, regulation, or order of the Commission, to destroy, mutilate, or alter any account, cost-accounting procedure, correspondence, memoranda, book, paper, or other record kept pursuant to this title." What does "kept pursuant to this title" mean? This makes sense as applied to corporate records and the corporate books. Can it be made to mean that every investment program must be filed, every bit of potential waste paper embalmed until the Commission gets around to ruling what may be destroyed?

I do not think that there is the need for any such wide delegation of powers as is given to the Commission in these sections. It goes beyond all rhyme or reason. It may help solve the unemployment problem perhaps by giving a volume of work to people who make up and send down an enormous mass of reports and to the people in the Commission who read these reports and then file them.

But all this elaborate delegation of power isn't necessary to provide the fundamental thing that everybody is agreed ought to be provided for in this act, which is that the stockholders be given full and complete information at periodic intervals in accordance with the standards already set by many of the investment companies.

If you will spare me one more moment, I should like, with apologies for my temerity, to end by making certain suggestions.

Approach the problem not on the basis of trying to legislate in this bill to cover every possible or conceivable abuse, every possible contingency, and a host of things which have nothing to do with protecting the investor. Keep the present bill down to the necessary minimum to stop the grave abuses which have been outlined to you gentlemen and which everybody will agree should be stopped.

Where the present bill goes beyond that and where the case is not at all clear, keep the legislation at the present time so as not to freeze into law one answer to a problem on which there is much to be said on both sides. Leave that to a little further experience. Time may prove that it is unnecessary, or time may prove that the suggested cure is wrong.

Make the bill clear, concise, and understandable. Leave in the minimum of the necessary elastic but be sure that in tailoring that elastic you provide that the people who are to be affected by it have some voice in the making of the necessary rules and regulations.

If you will proceed on that basis, which I think you will agree is both businesslike and statesmanlike, you will have the full support of

the responsible elements in the business for the resultant legislation. And if in the necessary wholesale rewriting of this measure you may wish the help of those with practical and technical experience, I can assure you that they will be more than glad to sit down with whomever you may designate and cooperate fully in working out legislation along the general lines which your committee thinks is wise.

Thank you.

Senator WAGNER. Are there any further questions?

(No response.)

I think that is all for today. Whom else will you gentlemen have?

Mr. BUNKER. We have four more in this group, a repetition of some of the same, Senator. We have Mr. McGrath of General American Investors, Mr. Bellamy of National Bond and Share, and Mr. Quinn and myself again on certain sections of the bill.

Senator WAGNER. You are coming back?

Mr. BUNKER. Yes; we are going to come back strong, dealing with other subjects. We do not want to comb over the same material again.

Senator WAGNER. Mr. McGrath and Mr. Bellamy will be the first two witnesses, then?

Mr. BUNKER. I think the exact order will be, sir, that I would go on first, and possibly Mr. Quinn, and Mr. Bellamy, or Mr. McGrath.

Senator WAGNER. On what basis are you going to proceed? Are you going to touch a new subject?

Mr. BUNKER. Oh, yes; entirely new.

Senator HERRING. He is going to get recharged over the week end.

Mr. BUNKER. Yes. We are not going to worry over these same ones again, Senator.

Mr. QUINN. Those are the ones I just touched on.

Mr. BUNKER. Those are the ones as to which Mr. Quinn said, "I will leave the subject for fuller treatment," and just left them alone.

Senator WAGNER. We will have no session on Tuesday afternoon. We will sit all day Monday. We will adjourn now until 10:30 next Monday morning.

(Whereupon at, 3:50 p. m., the subcommittee adjourned until Monday, April 15, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

MONDAY, APRIL 15, 1940

United States Senate,
Subcommittee on Securities and Exchange of the
Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on Friday, April 12, 1940, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, Downey, Townsend, Frazier, and Taft.

Senator Wagner. The subcommittee will come to order. Mr. Bunker?

Mr. Bunker. Shall I proceed?

Senator Wagner (chairman of the subcommittee). Yes, will you proceed?

ADDITIONAL STATEMENT OF ARTHUR H. BUNKER, EXECUTIVE VICE PRESIDENT, THE LEHMAN CORPORATION, NEW YORK CITY

Mr. Bunker. At the close of Friday's hearings it was understood I would produce for the record a memorandum which I had made containing Mr. Schenker's outline to me and my group on January 23, 1940, of the general terms of the proposed investment company bill as it then stood. Also a letter which I wrote to the Securities and Exchange Commission on January 6, 1940. I gladly do so at this time.

Senator Wagner (chairman of the subcommittee). They will be made a part of the record of our hearings.

(The two printed pamphlets referred to are here made a part of the record, as follows:)

The Proceedings of Conference Held Between Members of the Securities and Exchange Commission and Representatives of the Closed Type Investment Trusts, Held at the Offices of the Commission, 10 a. m., January 23, 1930

Present: Commissioner Healy and Messrs. Schenker, Goldschmidt, Smith, and Holland, and representing the Investment Trusts: Messrs. Bartholet, Bellamy, Bullock, McGrath, MacDonald, Jaretzki, Quinn, and Bunker.

Commissioner Healy opened the meeting by stating in general terms the Commission's contemplated plan of procedure. He said that it was not the intention of the Commission to try to ram a bill through Congress but rather to get their recommendations before Congress promptly and let it take its natural course. At the present time he said that the details of the bill had not been discussed between members of the staff and the Commission, although the staff at this time was ready to outline their recommendations to the Commissioners.

He hoped that they would be able to get the bill before Congress by February 1 or in other words, within 1 week. Before this time they were anxious to obtain all views on the recommendations which the staff were making and to that end the staff were instructed to outline to the representives of the industry what they were going to recommend in the way of regulations for the investment trust industry.

Commissioner Healy said that in view of this time schedule it would be necessary to receive the views of the industry during this week. He suggested that these views be first presented to the staff and he further stated that thereafter if a small representative group wished to sit down with the Commissioners for the better part of an afternoon, he would arrange for such a discussion.

There was considerable discussion by the representatives both then and again after lunch after they had heard three-quarters or more of the outline of the bill, about the difficulties of assembling the views of a reasonably large section of the industry and arriving at any considered opinions within such a limited period of time. Commissioner Healy finally suggested that he would agree to the representatives having a further conference with the staff for the purpose of commenting on and criticizing the outline of the bill next Tuesday, January 30 at 9:30 a. m. The representatives advised him that if 1 week was the maximum time which would be allowed in order to assemble their views they would have to confine their efforts to simply informing the larger group of representatives, some 40 in number, of the outline of the bill and advising them that the smaller group would continue to work for its own account but could no longer keep the larger group informed during the period prior to the bill going to Congress as they would be too fully occupied with their own studies in this matter.

Commissioner Healy suggested that there would be an open door with the Securities and Exchange Commission of possibly 3 weeks after the bill has gone to Congress, during which time the Securities and Exchange Commission would be open to suggestions or changes. After that time, or possibly after the actual introduction of the bill by Congress, the matter would have to be fought out in the good old American way before the several committees of Congress.

Commissioner Healy then instructed the staff to outline the bill.

* * * * * * *

Mr. Schenker then undertook to outline the bill.

The representatives had agreed among themselves to avoid in general any comments upon the effect of the proposed bill and to confine their questions to seeking for the explanations as to exactly what was intended. In general, this procedure was followed. Mr. Schenker did not read the bill nor disclose the proposed language of the bill but rather gave generalized extracts therefrom

* * * * * * *

General definitions.—For the purpose of defining securities, underwriters, etc., the definitions will in general be the same as described in the 1933 act, the 1934 act and the 1935 act. For example, Government securities will be defined as all securities guaranteed by the Government. Any other definition problems will undoubtedly come up and will be dealt with in future.

The biggest problem of definition is that of defining investment trusts. For example, the Commission does not want to catch banks. For example, the problem comes up as to what the First Boston Corporation is. If it isn't an investment trust, what is it?

In general, the staff has agreed that a company with fewer than 100 stockholders is a private company and shall be excluded from the bill. There shall also be excluded banks, common trusts and any real estate company, oil royalty company and investment trusts which are confined to handling funds of employees.

Classification of investment trusts.—This question was regarded by the Staff as complicated. There was a great difference in the minds of the staff between diversified trusts and nondiversified. They were thinking of two broad classifications: The diversified trust would be that trust which never had more than 5 percent of its assets invested in the securities of any one company and never owned more than 5 percent of any one company. In this type there was to be permitted an exemption on the question of owning no more than 5 percent of a company to the extent of a reservoir composed of 15 percent of the assets of the trust, although there was to be no exemption whatever as to having more than 5 percent of the funds of the trust invested in the securities of any one company. Therefore, it would be quite possible to own 100 percent of a number of companies providing the total value of each holding was not in excess of 5 percent of the trust's assets.

Therefore there were two distinct types of trusts in the minds of the staff, one of which was diversified under limitations such as described above, the other is hereafter referred to as a special type of trust, which is simply a trust that does not accommodate itself to such regulations. The staff said that there was a possibility of establishing some third division which would have no limitations at all as to the percentage that could be put into securities or any percentage ownership of other corporations.

Mr. Schenker advised he did not feel that he could recommend a particular form of tax bill but only recommend to the Treasury that there be no discrimination between the tax status of registered diversified trusts. He did agree, however, to recommend to the Treasury that the test of tax preference should no longer be based upon the redemption feature. In other words, open end trusts and closed type trusts of the diversified type were to be treated alike. So-called special type trusts were to have no tax preference. (The problem of whether the Securities and Exchange Commission should recommend a particular form of tax bill was discussed at great length later on.)

Mr. Schenker felt that one of the major purposes of having separate classifications is to let the stockholder know what type of company he is getting into and what the policy of that company will continue to be.

General powers of Commission.—The Securities and Exchange Commission reserves at all times the right to make further classifications as conditions warrant.

There will be exempt from the bill all companies which are intrastate, Hawaiian, Philippine, and other usual exemptions of this order.

The Commission will continue to have the power to grant exemptions in the broadest manner as conditions may arise and warrant, for example, relieving companies from other restrictions of the bill. A condition might arise such as the case under the Utilities Act where the Aluminum Co. had a large power plant and therefore could not be granted any exemptions until the Aluminum Co. itself had registered under the Utilities Act.

Registration.—It is to be unlawful, unless a company has registered, to use the mails, to trade upon the leading exchanges, etc. In other words, complete registration will be forced, the only alternative being liquidation.

There will be provisions with respect to registration that one will be deemed to be registered as soon as one files an application for registration, followed in time by announcement in greater detail what the company's policy will be and what classification the company elects, namely, diversified or special.

There will be provisions for revocation or suspension of registration if after due hearing it is found that there has been a willful violation or failure to comply with the provisions of the act.

Limitation of functions.—Here follows a discussion of the proposed limitation of functions:

1. No investment company may be a broker except to do business for its own account. In other words, it might purchase a seat on the exchange but it could do no business except in matters pertaining to its own portfolio.
2. The company cannot be a dealer in securities, except of its own issues.
3. The company cannot be an underwriter and distributor of securities, although it may be a counderwriter providing all of the securities are acquired for investment only and held for an adequate period of time, but even in this event it is suggested that the company probably will be forbidden to do even this character of underwriting unless it does so through some small subsidiary with a limited liability so as to protect the major assets of the company from the risks of underwriting.
4. The company cannot act as an investment counsel except for affiliated companies. (Affiliated companies are ones in which there exists an ownership of 5 percent or a greater amount.)
5. A company cannot buy securities on margin except for clearance transactions.
6. The status and regulations of any subsidiary are to be exactly the same as those of its parent.
7. The company cannot participate in joint trading accounts. (This problem had not been defined and discussion took place as to whether they would permit joint purchases and joint sales. It was not clear as to whether this would be permitted.)
8. No company can have any interest in the depositor of any fixed trust.
9. No investment trust shall buy any securities of another investment trust.
10. There shall be a provision against any form of circular ownership. For example, Company A, an investment trust, cannot buy shares of Company B, an industrial company, while Company B owns shares of Company A.

11. Affiliated companies and connections. In this matter the staff did not pretend to know what the Commission's views will be but they were prepared to recommend concessions as follows: After 1 year there should be no interlocking officers, directors, managers, or personnel between any two or more investment companies. For the purpose of this definition all the partners of any parternship were to be regarded as one individual.

12. The most controversial subject is that of establishing the relation of those who get the patronage of the investment trust, namely, the principal broker and the manager.

In general the staff felt that it was necessary to deal more severely with the broker problem than with the management problem. In the instance of both the broker and the manager, it shall be forbidden that they shall have a majority of representatives on the board of directors; in other words, there must be a definite, independent majority of the board.

In the case of the broker, he shall definitely not be permitted to hold the office of the principal executive, and possibly of none of the executive offices.

In the case of the manager, the maximum leniency would be to permit him to control the board of directors, although the staff was exceedingly doubtful about granting such permission.

13. There would be permitted interlocking directors between commercial banks, insurance companies and investment trusts, but there would not be permitted any interlocking officers between these groups.

14. The investment trust cannot have as an officer, director or manager, any member of the firm if the banker is an underwriter of any portfolio company. It was not clear whether the company could sell its portfolio holdings if the banker manager was to undertake underwriting securities of the portfolio company. (There was a suggestion that this might be enforced only if the investment trust held more than a certain percentage of the stock of the portfolio company in question. It was also not clear whether this was effective only in the event that the underwriter was one of the principal underwriters.)

Further, no member of a firm can be a director of an investment trust if any member is a director of a portfolio company.

15. The investment trust will not be allowed to purchase any securities from affiliated companies, officers, directors, or 10 percent stockholders, or from any partner who is an underwriter, but in the latter case must wait for more than 1 year after underwriting has taken place.

16. There shall be restrictions as to the formation of open-end investment trusts in connection with the rapidity with which they can be organized. Any individual or group of individuals shall be estopped from forming more than one such company in each 5 years.

17. There must be registration of officers, directors, and principal underwriters, and there shall further be some check by the Securities Exchange Commission as to who can be a director; for example, anyone who has been in jail within the previous 10 years will be stopped from being a director of an investment trust, or if he has been permanently enjoined by some court order from engaging in the investment business in general.

18. The question was again raised as to the revocability of registratior if there was willful violation of any fiduciary duties. Any such act of revocation, however, was to be disputable in the courts.

19. The staff was trying to establish some standard of personal liability for officers and directors to stockholders. It was suggested that such might be the same as the responsibility of the trustee under the Barkley bill.

20. There shall be no self-dealing, neither purchases from nor sales to, nor borrowing, nor any form of credit extension.

21. However, in investment trusts systems which already exist, there may be some transactions between companies but only upon an order from the Securities Exchange Commission.

22. A manager cannot act as an agent except as a broker of securities under standard fees. For instance, he cannot act as a real-estate broker or as a custodian, etc. (The staff was very uncertain about this restriction.)

23. *Management contracts.*—The present tendency of the staff is not to abolish management contracts, although there is very strong feeling to do so. No other country in the world has such an instrument and the usual practice is to manage on a basis of flat salaries. This is such a controversial subject that the Commission may reverse the staff. On the other hand, the staff is ready to recommend that management contracts of the following type be allowed:

(*a*) Compensation for a definite sum of money.

(*b*) Compensation fixed upon a percentage of the company's ordinary income, meaning dividends and interest.
(*c*) A percentage of the average net assets.
(*d*) Or, a combination of the above alternatives.

24. If a company has no manager, it may compensate its officers or managers on any of the bases above.

25. No management contract may be entered into for a period greater than 1 year and must in each instance be approved by more than 50 percent of the outstanding stock. It must be in writing and must fully describe all of the terms and compensation. Furthermore, it may be terminated by the company's directors at any time upon 60 days' notice. It shall be nonassignable. It shall be terminated automatically if the control of the company changes. Furthermore, the board of directors cannot completely delegate ultimate responsibilities, or, for example, it could not vote to turn over complete management to some body other than themselves.

26. The company shall be prohibited from changing more than one-third of the members of the board of directors between special stockholders' meetings called for such purposes.

27. It shall be forbidden to change the fundamental nature of the business, for example, from that of a diversified trust to a special trust, without first securing stockholders' approval.

28. *Capital structure.*—It shall be provided that hereafter the only class of investment trust security which may be issued will be common stock. It shall be forbidden to issue preferred stock or debentures and all such common stock must have voting privileges and carry preemptive rights (the latter being true, of course, except for redeemable securities).

It shall be forbiddne to sell common stock for less than net asset value. There shall be some separate treatment of this problem in the matter of issue of stock for property, etc.

No securities of any investment trust can be distributed unless it already has a net worth of $100,000.

There shall be established a maximum size for investment trusts of $100,000,000. This shall only apply in the matter of selling new securities.

29. With respect to all companies remaining in the business over a period of 5 years, they shall have only one class of securities, namely, common stock.

30. No company may issue any warrants, except short-term warrants of a maximum dating of 120 days.

31. Proxy requirements shall be the same as the 1934 and 1935 acts.

32. The company shall be prohibited from selling voting trust certificates at any public offering.

33. The staff requested that the representatives of the industry make counter suggestions on what limitations on capital structures should now be made and how voting rights shall be recast.

34. In the case of American investment trusts controlled by foreign interests, it should be unlawful for any foreigner to vote his stock if such foreigner owns more than 5 percent thereof. (It was suggested that this matter involved not only the Securities and Exchange Commission but the State Department and several other departments.)

35. The payment of dividends shall be governed by the 1935 act and it shall further be provided that no dividend shall be in contravention of the Securities and Exchange Commission rules. Regarding payment out of capital, etc., dividends could only be paid out of earned surplus and capital gains could only be distributed if they were clearly identified as capital gains.

36. Loans could only be made if consistent with the financial policy of the company and only as the result of arms-length bargaining.

37. No investment trust can borrow except on its short-term commercial paper and then not in excess of 1 percent of its total capital. In an emergency it can make application to the Commission for an exemption to this rule.

38. Repurchases of the securities of closed-end companies shall be accompanied by full disclosure of the asset value. The staff is trying to work out some plan with respect to this problem but is very much puzzled at the present moment.

39. It shall be provided that registration under the Securities Act can be accomplished by using the basic registration under the proposed investment trust act.

40. In matters of reorganization, voluntary dissolution, or any offers of exchange, plans must be filed and permission obtained from the Securities and Exchange Commission.

41. In the matter of representative stockholders' suits, there was a strong feeling that in connection with settling these suits, the Securities and Exchange Commission must be heard in court.

42. There would be a provision for formal reports to the Commission on a periodic, quarterly basis, and also special reports required under certain contingencies. Undoubtedly there would also be required supplemental reports by any manager of an investment trust. These reports would be a substitute for the present form 15-K of the 1934 act. All of these requirements would establish a law for minimum information.

43. The accounting systems would accord with the present Holding Company Act, giving to the Commission the constant power to examine, prescribe form, etc.

44. There would be a catch-all provision giving the Securities and Exchange Commission power to promulgate further regulations as conditions arose. For example, it might be necessary to establish regulations in connection with salesment for open-end or installment-company securities, for bonding officers and employees, for sponsors leasing office space to companies, for voting portfolio securities by the management. At the moment they are willing to leave these matters in status quo, but wish to retain the right to prescribe further regulations at any time it may appear necessary.

45. Tax preference is to be given to registered companies. Again staff suggested that it was not in their province to write a specific tax bill for the Treasury Department. A great deal of discussion ensued on this point. The representatives of the industry felt the contrary to be true. It was pointed out that for the past 4 years representatives had discussed the tax matter with the Treasury Department and while they had their sympathy, they had on every occasion had it pointed out to them that the Securities and Exchange Commission was the only branch of the Government that had fully informed itself in the matter of investment trusts and that any suggestions should emanate from that body. It was further pointed out that if the Securities and Exchange Commission simply recommended to the Treasury Department that the same relief from taxation be accorded to the closed-type companies which was now accorded to the open-end companies, that in fact the closed-type companies would obtain no relief at all, and it would only insure their continual and constant liquidation. It was suggested that it should become the duty of the Securities and Exchange Commission to point out to the Treasury Department the fundamental difference between any company which was engaged in constantly selling its securities and the other type of companies, namely, the closed-end type. It was suggested that the industry send down copies of the memoranda which they had submitted to the Treasury Department in this matter and that the staff would undertake a study of this problem.

THE LEHMAN CORPORATION,
New York, January 6, 1940.

Commissioner ROBERT E. HEALY,
Securities and Exchange Commission, Washington, D. C.

DEAR COMMISSIONER HEALY: It seems to me that it might be helpful to both of us at this time to review in a very general way the activities of the so-called Investment Trust Committee with relation to the Commission and its study of investment trusts.

It is a little over 4 years now since your Commission began its study of investment companies. At the very beginning, you asked us to form such a committee. That committee worked with you and your staff on the initial questionnaire, to its satisfaction and, I trust, to yours. You stated at that time, and have repeated on several occasions since, that it was your purpose to discuss your conclusions in full with our committee before submitting any recommendations to Congress.

In April 1938, a conference was held between your staff and our committee on the question of procedure. At that time your staff suggested that we form a subcommittee for the purpose of working with you and your staff when the time should come that you wished the considered views of the industry on the proposed regulations. Mr. Bartholet and I were asked to serve as the committee.

If various recent press comments are true, it would appear that your factual reports on the study are nearing completion and that you may soon begin with the task of writing your recommendations to Congress. If that is the case, the question of timetable and procedure becomes extremely important.

When Mr. Bartholet and I discussed this subject with you and Mr. Schenker on March 1, 1939, you again emphasized that you would prefer to work through

a committee rather than to have discussions on the subject with representatives of individual companies and groups. In general, you expressed the desire to have substantially the same procedure followed that was adopted in connection with the initial questionnaire. We called your attention to the fact that the work which we did on the questionnaire absorbed the better part of the time of a number of people for over 6 weeks, and expressed our opinion that the task of assembling the views of the industry on this far more important subject of proposed regulations would undoubtedly require a somewhat similar period of time. In this connection, we undertook to form a group of representatives of as many of the closed-end companies as possible. We did not, however, at our meeting on March 1 establish any timetable or schedule for the purpose of effecting our cooperation.

Later, on May 16, 1939, after we had had several talks with representatives of the companies which we represent informally, Mr. Bartholet and I went to Washington at Mr. Schenker's request, for a general discussion of the procedure which was to be followed in connection with these recommendations. We pointed out to the staff at that time that we thought it would be impossible for us to present to them the considered views of investment company representatives on the subject of legislation and regulation if sufficient time were allowed us but suggested that it would be of great benefit to us if it were feasible for the Commission to write out some plan of procedure which was agreeable to it. This seemed desirable to all those attending the conference, and Mr. Schenker was to consult with the Commission and advise us further. The Commission was, I believe, very fully occupied at that time with matters of internal change, and after a series of telephone calls with Mr. Schenker, it became evident that no plan or schedule could be developed at that time.

However, it now seems to us essential that this question of a plan of cooperation should be resolved. Mr. Bartholet and I informally represent a very large section of the business and we are concerned that we should be able effectively to discharge our responsibility to the other companies. Our relations with the industry are all upon an entirely informal basis, the very nature of which could easily lead to misunderstanding. At the present time, these various individuals are relying upon the opportunity to express through us their views and criticisms upon such recommendations as the Commission proposes to make to Congress, before such recommendations are submitted to Congress.

In an understanding of this sort, time is of the essence. If, for example, we were notified one day to be in Washington the next to hear the recommendations, to report back to the industry within another day, and return to Washington with views of the industry upon the third day, the situation would not be capable of fulfillment. Altogether in our group are directly represented between thirty and forty companies. It is necessary to have a few days' time to even get such a large group together. Then, to obtain their considered and diverse opinions on a matter as controversial as that of regulation of their trusts, should call for a series of meetings, debating involved questions.

Mr. Bartholet and I do not doubt that, if given adequate time, we could perform this task, namely to assemble and refine the collective view of the industry as to any suggested recommendations.

In our opinion, however, the very nature of the problem and the large number of people with whom we must confer would require a certain amount of time to produce any considered and thoughtful opinions, representative of the business.

We are extremely anxious to cooperate with the Commission in this matter. But we do feel that the above matters are of such importance that we should call them to your attention and ask you to be kind enough to give us an early expression of your opinion.

Sincerely yours,

A. H. Bunker.

POSTAL TELEGRAPH

Telegram from Washington, D. C.

January 19, 1940.

Mr. Arthur H. Bunker,
The Lehman Corporation, 1 and 3 S. William Street,
New York, N. Y.:

Am prepared to discuss on Tuesday, January 23, 10 a. m. with your committee major aspects of staff proposed recommendations to commission. Shall also discuss procedure with you at that time.

Robert E. Healy.

Mr. Bunker. Now, Senators, there was some discussion at the last hearing regarding the opportunity the industry has had to discuss this proposed legislation with the Securities and Exchange Commission. I am very glad this matter has been brought up, since there seems to have been the feeling that our industry has had full opportunity, perhaps every opportunity, to discuss the bill with the Securities and Exchange Commission. That is not so.

Insofar as the facts are concerned I do not believe there is any dispute between Judge Healy and ourselves, but I do feel that the crux of the matter has not been brought to light. We do not in the slightest degree challenge anything Judge Healy and Mr. Schenker said in this respect but we do not believe the situation is clear before the members of this subcommittee.

The facts, which are unchallenged, however, are these: We did not have adequate opportunity for preparation before the conference with the Securities and Exchange Commission in January. We did not have an adequate opportunity to present our case when we did appear. And we have never seen this, or any other bill, until it was introduced on March 14. Rather, a memorandum which I am herewith submitting, shows that for 2 years we have made every effort to secure an opportunity to collaborate in the preparation of a bill; and you will see that we protested to the limit of our ability against the haste and the lack of opportunity to so cooperate. Once again this was reiterated by me on January 30 in my appearance before the Commission, and I should like to introduce for the record a copy of my statement made at that time.

Senator Wagner (chairman of the subcommittee). That will be made a part of the record of our hearings.

(The printed document referred to and entitled "Opening Statement Made by Arthur H. Bunker at Meeting Tuesday, January 30, 1940," is here made a part of the record, as follows:)

Opening Statement Made by Arthur H. Bunker at Meeting Tuesday, January 30, 1940

Present: All Commissioners of Securities and Exchange Commission except Chairman Frank, also Mr. Schenker and members of staff.

Before proceeding with such discussion of the proposed legislation in respect of investment trusts as the limited time at our disposal makes possible, we would like to protest respectfully but vigorously against the procedure and time schedule which has been outlined to us.

For a period of over 4 years the investment trust industry has been cooperating with the Securities and Exchange Commission in its investigation of the industry. Valuable help was accorded to the staff in the preparation of its questionnaire at a time when the staff was as yet unfamiliar with the basic problems and could not by itself have prepared as thorough-going and useful a questionnaire. After that the industry voluntarily made available to the staff of the Securities and Exchange Commission a mass of information which would have taken years to adduce by ordinary legal processes. Full cooperation was given at public hearings.

All this was gladly done. It was done, however, with the expectation that full opportunity would be given to the industry to discuss with the Commission and its staff any proposals for regulation of investment trusts. In line with this understanding we were called to Washington 2 years ago to initiate discussions in regard to basic principles and details of regulation. One preliminary meeting was had. We have ever since been waiting, ready and willing to come down to continue these discussions, have repeatedly expressed our readiness to do so, but have been told that the matter was not ready for discussion until just 1 week ago when we were invited to Washington and the barest outlines of the bill were given to us.

We were told we could have only a few days to submit our views. Frankly we were surprised. We have for 2 years made every effort to insure adequate time for this phase of the work, and even wrote you in December asking for adequate time.

We earnestly protest that we are entitled to this opportunity for discussion and we urge on you strongly that some such procedure is the only orderly way to go forward. After having spent 4 years in investigating investment trusts we are frankly surprised that the Commission is unwilling to set aside a few weeks to discuss the soundness and practicability of its proposals with representatives of the industry. We had believed it to be your desire to go to Congress and state that you were submitting proposals for the regulation of investment trusts reached after having given representatives of the investment trusts an opportunity to be heard. In our opinion this does not constitute a hearing. It is true that there have been statements of a general nature made by various persons appearing in the investment trust study hearings, but there has been no discussion of the details of legislation and above all there has been no testing of the legislation proposed by your staff against the background of practical experience in the management of investment trusts.

True, it has been said that the door will not be closed upon the presentation of your recommendations to Congress, that thereafter not only will we have the constitutional right to be heard before Congress, but that the doors of the Commission itself will be open for further discussion of the proposals. But what does this mean? Certainly it is a very different thing from hearings before recommendations have been released. It means that the Commission is proposing to make recommendations to Congress first and discuss such recommendations afterwards. And it must mean one of two things. It must mean either that the Commission is admittedly premature in making its recommendations or else that the Commission feels that it has completely explored the subject and therefore the suggestion for later conferences will be futile. We admit we have no right to be heard in the matter, but we wish to go on record that the course we have suggested seems the only reasonable one.

In the hurried time at our disposal we have divided into three categories the individual items of the proposed legislation as outlined by Mr. Schenker last week.

These classifications consist of—

(a) those items which commend themselves for approval;
(b) those items which we believe are susceptible of satisfactory modification;
(c) and that final group which we believe should be disapproved completely.

There are a substantial number of provisions of which we approve, and more which we believe to be susceptible of satisfactory modification, and very few which we believe should be completely eliminated.

We cannot overemphasize to the Commission that our group is fundamentally sympathetic to promulgating regulations that will eliminate the many abuses that have been disclosed by your four years' study. But just as firmly we believe that this should be done while still leaving the investment trust free to function in an important way in the national economy.

We believe that this can be done, but do not believe the form of your contemplated bill is the means. It is our opinion that your recommendations go far beyond any necessary restrictions; recommendations which if applied to industry in general would induce general paralysis and stagnation.

We feel that the investment trusts with their $4,000,000,000 have been almost sterilized as a supply of capital for business.

This situation is indeed serious for our industry.

If we were to explore the objectives of the Commission, it might well be we would find them not far from our own. If this should be the case, given time, it should be possible to work out regulations that would achieve these objectives and still stand the test of practical experience in the management of trusts.

We are prepared to discuss in greater detail some of the more controversial aspects of the proposed bill. Before we do this I think Mr. MacDonald would like to make a general statement in behalf of the International Bankers Association. It just happens that in addition to being a member of our small group, Mr. MacDonald is chairman of the investment trust committee of the International Bankers Association.

Mr. Bunker. Mr. Schenker outlined to us then the general scope of the proposal he intended to make to the Securities and Exchange

Commission. In many respects the proposals are substantially the same as the provisions in the present bill, but it is important to note that although we had many of the proposals in a general way, we never saw the language contained in the proposed bill, and the importance of this can be seen when you come to consider the many complicated provisions of the bill, such as section 10, which I expect to take up this morning.

It is one thing to discuss the general objectives of section 10, and it is quite another thing to analyze the complicated provisions in the actual draft of the section, and then discuss the provisions in the actual light of that language.

The same thing is true of the most of the other provisions of the bill. They are complex and demand the most careful study and consideration in order to understand their meaning, and especially their implications.

We are not complaining. We had no right to be heard more fully by the Commission. We do not question that the Commission may have had reasons which seemed valid to them for the course which was followed. That was a matter within the discretion of the Commission. But it is important that the Senate committee does not receive the impression that the bill now being considered was worked out in collaboration or agreement with the industry. That is just not so. We stood ready to work out a bill with the Securities and Exchange Commission, but were not given that opportunity.

Now, as to the matters which I would like to present today: On Friday I had the privilege of presenting to your committee the principles which some of my associates and I in the closed-end investment company field believe to constitute a proper basis for legislation aimed at regulating investment companies. Mr. Quinn has given you our general views regarding the bill which is now before your committee and has discussed in some detail the provisions delegating what we consider far too broad power to the S. E. C., and also certain specific provisions of the bill which we do not consider either appropriate or necessary.

Today I should like to lay before you my views as to the effect which the bill as now written will have upon the whole question of the management of investment companies. As I told you last Friday, I consider the question of competence of management to be of paramount importance in the successful operation of investment companies, only exceeded, perhaps, by the obviously necessary requirement that any management to be successful must be honest. As I said to you on Friday, for some reason the valuable and voluminous study of our industry by the S. E. C. has not concerned itself with the constructive side of this management problem. It is true that the S. E. C. report was, in essence, an indictment of those managements which had proved themselves to be incompetent or worse, but there was nowhere apparent an adequate evaluation of the enormously important role that competence plays in the actual operation of investment companies. And I think that as a result the S. E. C. has prepared a bill which goes far to disrupt competence in its effort to root out malpractice. Competence certainly cannot be created by legislation of any kind, but it can easily be destroyed by legislation which is ill conceived. Those of us who are in this business are daily reminded of the practical side of management and the frequently insurmountable difficulty of providing

first-class workmen to do the job. My plea is that this already difficult problem shall not be unnecessarily made more difficult.

Now the bill throughout directly and indirectly affects the management problem. Indeed, the whole bill looked at from one viewpoint is simply an effort to restrain and restrict management, presumably in the interest of investors and of the public. With this objective in view, the bill undertakes to say who and who may not manage investment companies.

I have given a great deal of thought to the proper manner of presenting to you the effect of this bill on the whole question of the future management of investment companies and as a result should like, with your permission, to approach the matter by telling you directly and in nontechnical language the practical effect that the pertinent provisions of the bill will in fact have. In this way I believe that I can demonstrate to you the problem with the greatest possible clarity. I may say here that the sections of the bill to which I refer are primarily the rather complicated ones of section 10 and parts of other sections which have an indirect bearing thereon. Therefore, if you will assume for the moment that the statements I shall make are correct, I shall later point out the specific provisions of the bill on which they are based.

It is my considered opinion that the present bill must in its cumulative effect eliminate from the affairs of investment companies—and by the affairs I mean from service as directors or officers of such companies—all persons who fall into the following categories: (*a*) directors and officers of the 1,500 leading corporations in the United States, and (*b*) all members of important investment banking firms and brokerage houses.

I should like to indicate to you just what these eliminations mean. According to the S. E. C. report there are on the average 1,500 securities held at one time in the aggregate portfolios of American investment companies. The coverage indicated by this statement is best realized by recalling that there are only approximately 1,100 companies whose securities are listed on the New York Stock Exchange. It seems to me fair to say, therefore, that the 1,500 securities held by all investment trusts comprise in a general way all companies of any importance listed on any American exchange, as well as a number of unlisted though worthwhile companies.

Generalizing further, it is not an exaggeration to characterize any such list as comprehensive of what would popularly be known as the leading American companies. Now the boards of directors of these companies would probably range between 7 and 25 directors each, say 15 on the average. This would mean that perhaps 22,500 would be a fair guess at the total number of directorships on all these boards. Allowing for duplications, of which of course there are many, I should think that 15,000 would be a reasonable enough estimate of the number of different individuals who are members of the boards of these 1,500 leading companies.

By any realistic standard, these 15,000 people should be regarded as embodying the best industrial and commercial ability in America, and one should not forget to add to them the unknown number of officers who are not members of their companies' boards but who would likewise be excluded from investment company affairs.

Now I should like to recall to you at this point the fact that investment companies invest primarily in equity securities of American industry. I think the directors and officers of these industrial companies must be regarded as experts in equity securities, as the values of these securities are, after all, simply reflections of the earning power of the companies that these men manage. So the exclusion from investment company affairs of the whole of these top industrial and commercial classes of the country is a removal of professional assistance from these companies comparable to prohibition by law in connection with legal problems of the use of the leading 15,000 lawyers of the country, or in engineering work the leading 15,000 engineers. In any of these situations this would be regarded as a tremendous degree of exclusion.

Further, in addition to these top industrial, commercial, and merchandising people, the present bill would exclude investment bankers and the more important brokers. I am only too well aware that neither of these classes has been outstandingly popular during recent years, but one cannot overlook the fact that they constitute the groups most skilled and experienced in the handling of equity securities—far more so in this special field than are the commercial bankers, savings bankers, or insurance company managers of the country.

Now, these people are to be excluded from the investment company business. And what is the investment company business? It is of course, the business of investing and conserving the funds of other people. Naturally it is not the only business or activity that has these characteristics. There are many other types of institutions which are faced with problems of investment more or less similar to those of the investment company. For example, our colleges and universities, hospitals and various other endowed institutions, museums, insurance companies, commercial banks, and savings banks. All have the common problem. All of these institutions have trustees or directors, one of whose principal duties is the conservation and investment of funds. Who are these trustees and directors as a general rule? The answer is obvious. They are the persons in the community or State, or, if the institution is a national one, in the country, who are best qualified by experience, integrity, and judgment to handle the responsibility entrusted to them. They are, in fact, drawn from the very groups we have just been discussing and which we say have just been excluded. There are no laws (except in the case of investment banking directors of banks) prohibiting their association with investment activities, and the penalty would be great if such laws came into existence.

Nor is the individual under any such restriction as to his private needs. Indeed, it is certainly the normal procedure of an individual wishing advice about investments, to go to some person who is familiar with investments. If he wants advice about any other phase of business, he would certainly seek out someone of his acquaintance in that business—the more successful and eminent the better.

But this bill says that alone among all the people in the United States needing or seeking advice or assistance as to the investment of their money, the stockholders of investment trusts are to be uniquely isolated from these principal normal sources of financial advice. I can't believe that there is any problem inherent in the investment company that requires that it, of all American institutions,

be singled out for complete deprivation of the benefit of the counsel of those persons who are best qualified to give it.

Whatever views one may entertain with respect to the permanent operating personnel, it would seem to me that the problem of the board of directors is easily distinguished from that of the operating group. In my opinion, one of the main functions of a board of directors is to bring to the professional managerial class the varied viewpoints of the world outside the walls of the particular business—to give the management a broad background of enlightenment and advice. The necessity for this infusion of outside wisdom is recognized in every great industrial company of the country, and nowhere is it more essential than in our industry.

Now, I am fully aware that nowhere in the bill is there a categorical prohibition of the continued association of these classes with the direction and management of investment companies. However, I shall now show how the proposed bill inevitably would operate to bring about this result.

Before considering those provisions which deal directly in prohibiting directorships it is appropriate to examine section 9 (a), as this section in my opinion would deter many individuals from accepting positions on the boards of investment companies. Section 9 (a) requires that all directors register. This provision has in view some very worthy objectives. For example, the Commission will deny the right to register—which means the right to serve in any capacity with an investment company—to any applicant who within 10 years has been convicted of a felony in connection with a financial transaction, or who has been enjoined by the order of a court from acting generally in any financial capacity. These restrictions are certainly sound and might well be incorporated in the statute in some other way. There is no necessity of requiring affiliated persons to register with the S. E. C. in order to accomplish this objective. The bill further provides that the application of a director for registration—

shall contain such information and documents, in such form and such detail, as to such person * * * as the Commission may by rules and regulations prescribe as necessary or appropriate to effectuate the purposes of this title.

Now it seems to me quite possible that the Commission might decide that it is wise to have each individual reveal his personal financial condition, a list of all of his security holdings and debts and other matters which have been universally regarded heretofore as completely private. It might well be regarded as pertinent to make the registrant reveal the financial condition of all of his partners. Certainly, most men of affairs would think twice before they would subject themselves to these possibilities.

Now as to the direct prohibitions of section 10. The subsection that gets to the heart of the directorship problem is 10 (e). It says in effect that anyone who is a director of any company, any of whose securities are owned by the investment company, cannot be a member of the board of the investment company unless the investment company owns 5 percent or more of the stock of such company. I do not believe that this latter exception would cover many situations. Out of one-hundred-odd securities in my own corporation, only two or three would be exempted thereby. Under the proposed bill, wherein the diversified company one is largely kept down to investment of 5 percent I am sure the exemptions would be negligible.

In short, I think without stretching the point at all that section 10 (e) can be regarded as all-inclusive in keeping practically the whole top class of industrialists, merchants, and so forth, from being on the boards of investment companies. I have told you how large and important a class this is.

Indeed, if there had been any doubt in my mind as to the meaning and intention of this section 10 (e) (1), it was removed during the hearings on April 8, when Senator Taft asked Mr. Schenker:

> The result is * * * no investment company could have as a director or officer any director or officer of a stock listed on the New York Stock Exchange?

To this Mr. Schenker replied: "That is correct, sir."

The second part of this subsection provides that one cannot be a director of an investment company and of a portfolio company if he, or any of his partners, is an investment banker or broker. For the partner of a prominent banking house this provision is almost enough to rule him off the board of any investment company, because he or his partners collectively are represented as a rule on the board of a fairly large number of companies. It would, in this instance, be impossible to suggest either that the investment company should be denied the right of investing in such a broad group of leading stocks, or, on the other hand, that all of the partners would resign individually their positions on these other boards. But even if the banking house could meet this condition, it seems to me it would have to retire from the board by virtue of subsection (f) which provides that no investment banker, broker, or partner of such firms can be on the board of an investment company if they serve as principal underwriter for any company whose stock is owned by the investment company to the extent of the uninfluential amount of one-half of 1 percent. Clearly the investment banker in the face of these provisions has but two alternatives, namely, to give up his investment company affiliations or to get out of the investment banking business. It is probably unnecessary to labor this point further by making it clear that if the investment banker remains on the board of a substantial diversified investment company, he would, for practical purposes, eliminate his banking firm from affiliation with subsequent underwritings of the leading American companies.

Now the net effect to these direct prohibitions upon individuals from being directors of investment companies will naturally remove from the present boards of investment companies a large number of directors. A very real problem, indeed, will be that of trying to find adequate replacements.

In addition to these direct provisions against individual directorships are a number of other provisions dealing with the problem in a different way, namely, by prohibiting that majorities of boards shall be composed of certain classes of peoples. The prohibitions occur in subsections 10 (a) (1) and (2). For the moment it is enough to remark that they forbid that the majority of an investment company board shall consist of members of a banking firm, or brokerage partnership, or those who act as managers, investment advisers, or principal underwriters. This apparently is to be true whether or not the particular groups so prohibited happen to be the largest stock owners or not; or, in other words, happen to be that group who normally and usually would be represented on the board of a company in a control position.

Then there are further prohibitions under subsection 10 (c) against the banker and broker, to the effect that they cannot, or any of their partners cannot, be directors of more than one investment company except under that special situation of the so-called investment company system. Then again, the bankers and the brokers have further prohibitions under subsection 10 (d) (3) which says, in effect, that any person who regularly acts as broker (who is, of course, the investment banker or broker) cannot be the manager of an investment company.

Now, we of the industry are aware that the question of segregating investment bankers and brokers from the management of investment companies has been debated for a long period of time by members of the Commission. Judge Healy said before this committee 2 weeks ago, regarding this matter of segregation, the following:

> Nor does the bill require the segregation of investment bankers, brokers, and distributors from the management of investment companies, a step which various officials of investment companies advocated in the hearings before the Commission. However, to prevent the evils which may result from the divided loyalties, certain specific restrictions are imposed on affiliations involving conflicts of interest.

I appreciate the fact that the authors of the bill have attempted to avoid segregation, but I consider their attempt unsuccessful. For I believe that this bill not only provides for segregation of the investment company from the banker and broker, but I am forced to believe that the segregation is almost complete from that whole leading class of industrialists and merchants as well. In my opinion, this bill is the essence of segregation. It has avoided nothing but the word.

As a young man I was interested in magic and was a great disciple of Houdini who was then, and probably has remained, the greatest magician of our age. His great escape act used to be that they would handcuff him and rope him and finally nail him in a packing case, and in a minute he would come out smiling before the audience.

This bill has provided handcuffs and ropes for the industrialist. For the banker, it has taken the handcuffs and ropes and bound him and nailed him in the packing case. I do not think the banker can get out. In fact, I do not think he can ever get in. I deplore the separation of these useful people from their useful place in the operation of this business.

One more word about the director problem, because there are still some more provisions that would bother him. I think it is fair to say that, in general, the function of the directors is to keep the company in contact with the outside world and to be responsible in the determination of general policy. In the matter of the investment company, this would mean that they would be responsible for such major questions as to the general program of acquisition or disposition of securities, and in a general way, for the determination of fields of investment.

But this is a very different thing from asking them to pass upon every minute purchase and sale, to examine every report and recommendation made by the operating staff, and to consider every daily investment opportunity which may arise. I am sure you will agree that these distinctions between the operating staff and the directorship staff are fair distinctions.

Section 30 (e) makes life very difficult for any director who does not follow every detail of daily operations. This section has a very worthy purpose, which is to keep any affiliated person from trading

against the operations of his company. It seeks to accomplish this by making every director the subject of censure by his board of directors, possibly also by the S. E. C. and by the public. It does it this way. It requires that every person registered under section 9 must within 30 days after the close of each quarter of the fiscal year, submit a statement to the board of directors showing the amounts and dates of every purchase or sale made for his account of any securities of a company, the securities of which were purchased or sold by the investment company during such quarter.

But under section 30 (c) the Commission would have the power to require an investment company to transmit this report of such transactions to the stockholders of the company. Under section 30 (a) its filing with the S. E. C. may be required—which in the normal case means newspaper publicity.

The only point I am trying to establish is that there may well be, and surely will be in many instances, innocent transactions in the same securities by the director of a company as there were by the company. As the provisions now read, I do not believe they will deter the dishonest individual from operating, but I do believe they might inadvertently destroy the reputation of an innocent and honest man. I should personally not agree to subject myself to these provisions if I were an independent, nonoperating director and therefore one in no position to maintain information on every security transaction every day.

I have attempted to take the complicated and sometimes puzzling provisions of section 10 and its related sections and subsections and to point out their actual results in operation, and how and why these results are inevitable. I have tried to show not only the cumulative effect of these provisions on the problem of putting together managements for investment companies in the future, but the effect on existing management relationships as well. And this latter subject is a particularly important one because the bill, if it should pass in its present form, is going to upset, if not destroy, numerous management organizations which have been laboriously built up over the past generation, and will ruthlessly abrogate contractual rights which flow from contracts freely entered into and satisfactorily maintained for many years.

I say this with all deference to the remarks made by Judge Healy in his opening statement at these hearings when he said: "The bill's provisions have been scrupulously adapted to the existing diversities of investment company organizations and functions." I am sure that the judge was sincere in the general proposition which he advanced, but I should like to show you just what the management restrictions in the bill would do to one large investment company.

I do not like to refer so continually to my own company but these particular provisions of the bill happen to strike us with especial severity and I think it would interest you to see what the practical effect of the proposed bill would be in the case of an actual company which has thus far operated successfully.

The Lehman Corporation was established by the firm of Lehman Bros. in 1929. In its articles of incorporation and in the prospectus under which it was issued to the public it was made abundantlyy clear that the corporation would be managed under a management contract by the investment banking firm of Lehman Bros. and that its board

of directors and officers would be entirely composed of the partners, employees, and direct nominees of Lehman Bros. The Lehman Corporation has had a successful record; in fact, I believe it ranks among the first, second, or third of all investment trusts in existence. During its whole history our records do not disclose that any stockholder has demanded or suggested the change of our management, or the exclusion of any individual or class of individuals from the board of directors or management. The directors of the corporation have been reelected annually by a majority of the stockholders without opposition. Original stockholders and persons who have subsequently become stockholders are presumably fully aware of the relationship of the Lehman Corporation to the firm of Lehman Bros.

What will happen to the Lehman Corporation if section 10 of this bill stands? First, it will be absolutely necessary to turn over a majority and probably all of the board of directors to persons not affiliated with the firm of Lehman Bros. and not affiliated with any of the 100 companies represented in the portfolio of the company; second, the firm of Lehman Bros. will have to decide whether it wishes to remain as principal broker of the corporation, or as manager. A decision to remain as manager would entail retirement of the firm from the investment banking business in which it has engaged for 90 years, which is, of course, entirely unthinkable.

The following paradoxical situation would thus be created: Elsewhere in the bill it is provided, and properly provided, that managements cannot be changed without the consent of stockholders. But here the operation of section 10 would require a legally elected management, presumably entirely satisfactory to the stockholders, to turn over the affairs of the corporation to a new group unknown to the stockholders. True, the mechanics of this abdication would be in accordance with legal procedure. Presumably, a new slate of directors would be offered for election by the stockholders at the next meeting. Under existing corporate procedure, it is probable that they would be elected. Who they would be, and whence an almost completely new board could be drawn that the present management would wish to endorse, by inference (the whole field of American industry being closed in this choice), is a problem that I am not prepared to solve now. We have indicated before that we think it would be fraught with the most serious practical difficulty, but—following along the procedure—this new board of directors, totally independent of Lehman Bros., would then be required to find substitute officers and make new management arrangements to replace the Lehman Bros. personnel which is now active in the management of the corporation.

Thus the net effect would be that the present stockholder who has exercised his own judgment, and for better or worse, and however wisely or unwisely, has decided that he wants to own shares in a company managed by the firm of Lehman Bros., will by law be told that he can no longer employ their services, but has two alternatives; one, to accept the services of a group quite unknown to himself who will in future manage his money; or, if he does not wish to go along with this solution, he may sell his stock.

Frankly, we have no specific idea as to what the average stockholder may do in these circumstances, but it is reasonable to suppose that at least a fair number of stockholders will decide that they would prefer

to sell. If this decision should be made by any large number of stockholders, it would clearly have a most unfavorable effect on the market value of the investment of the remaining body of stockholders.

And there is in this case the final irony that the firm of Lehman Bros., for its own and family accounts, owns more than any other single interest in this stock, and has always maintained a very large investment in it—a very realistic guaranty that the managers of the corporation would always find their interests and those of the stockholders in general agreement.

I have cited this illustration because I happen to be familiar with it, and not as necessarily typical of every case of management and control of an investment trust by an investment banking firm. It does seem to me, however, that the consequences of the present bill in the case of the Lehman Corporation would constitute a reductio ad absurdum and should serve to justify serious reconsideration being given to the blanket proposal for the practical segregation of bankers and industrialists from the investment trust industry.

Now of course I do not approve of any legislation (such as this bill) which would cause such a violent and, to my mind, unjustified disruption of contract rights and business relationships which have operated to at least the general satisfaction of all concerned, even during the past 10 troubled years. I am sure that any reasonable man would agree with my point of view, unless it could be shown that there were such serious and inherent dangers in the relationships against which the law was directed that they could only be adequately guarded against by the particular provisions proposed.

Now what are these dangers? In general, they are the various conflicts of interest which quite obviously exist when persons occupy dual relationships. In the complexities of modern business life these dual relationships are inevitable and the choice of appropriate means for protecting against them is always a question of degree. In the history of investment companies, the S. E. C. has shown you a list of abuses which arose out of conflicts of financial interest between managements and stockholders of these companies in which managers enriched themselves by the improper use of the stockholders' funds. This was true of managers who were investment bankers and those who were not. In the case of investment bankers, it was perceived by the S. E. C. that there were additional conflicts of interest between them as managers and directors of investment companies, over and above those conflicts which might be inherent in the case of other types of managers or brokers. The S. E. C.'s answer to the very real problem raised by the revealed abuses, and by the latent possibility of the recurrence of such abuses, has been the complicated provisions of section 10 which we have shown you to have the practical effect of segregation.

Now I recognize the dangers which exist, but I think there is another answer to them and one which permits the continuation of many desirable existing relationships while giving adequate practical protection to stockholders. Therefore, I should like to discuss this problem in the light of the six principles which I stated on Friday as appropriate for the regulation of the industry, particularly one of them, namely, the prohibition on self-dealing between affiliated persons and investment companies. If you will consider this prohibition, which exists in the proposed bill and which I think is not only appro-

priate but very necessary, you will see that it eliminates a very large area of potential abuse arising out of the conflict of interest between management and stockholders, whether the management happens to consist of investment bankers, brokers, or anyone else. Even a banker or broker, if he cannot buy from, sell to, lend to, borrow from, or otherwise directly or indirectly deal as a principal with an investment company, has only the most theoretical opportunity to harm the stockholders of that company. You will find, I am sure, that the prohibitions which I have recommended cover all potential conflicts except that class of abuse which was mentioned the other day and which may be generally described as the use of investment-company funds to purchase securities of some other company for the purpose of establishing an investment banker as underwriter of the company whose securities are purchased. Admittedly, this possible field of abuse is open.

Now if there were to be no other provisions in a regulatory bill, perhaps this would be serious. However, the present bill proposes that if an investment company owns more than one-half of 1 percent of any class of securities of a portfolio company, an investment banker on the board of the investment company may not be an underwriter for the portfolio company. As I have shown before, this particular provision as now written would simply mean that no investment banker would be a director of an investment company. But suppose the unrealistic one-half of 1 percent were to be raised to some more sensible figure—for example, 5 percent, which seems to be a percentage set elsewhere in the bill as the point at which an investment ceases to be a casual affair and begins to take on some aspects of influence. If there were such a realistic percentage limitation written into the bill, it would permit investment bankers to serve on the board of investment companies without the danger of having their firm eliminated from important underwriting business merely because of some minor and casual investment on the part of the investment company. But at the same time such a provision would protect the stockholders of the investment company from the misuse of the company's funds to buy underwriting business for the bankers. The S. E. C.'s answer to this may be that there are some situations in which ownership of 5 percent of the securities of a company would constitute by far the largest single holding and would give the owner and his banker friends an influential voice in directing the underwriting business.

I am free to admit that there are certain theoretical situations where something like this could happen. But they are rare and in my opinion would more than adequately be handled by the provisions in the proposed bill calling for the fullest publicity for all acts and investments of investment companies. It seems to me inconceivable that in the face of self-dealing prohibitions, percentage limitations on underwriting, and complete periodic publicity, investment bankers, whatever their intentions, would be able to any dangerous degree to misuse their relationships to investment companies to the practical disadvantage of stockholders. As I have said before, this is a question of degree.

Before leaving this subject, I think I should call your attention to the fact that the one-half of 1 percent restriction on underwriting would in fact prevent a banking firm affiliated with an investment

company from joining a group making a public bid on bonds of a company, sixth-tenths of 1 percent of any of whose securities were owned by the investment company. It seems incredible that any such prohibition was in the mind of the authors of this provision—but there it is.

Further—and finally—I must mention briefly the suggestion that, in the case of broker managed investment companies, there exists a danger that the broker will be tempted to force the company into unnecessary trading merely for the sake of increased commissions. There may be cases of this. I do not know. But aside from the pettiness of such a kind of impropriety, I am quite certain that a combination of quarterly publicity for brokerage fees paid, and the heavy hand of the appropriate committees of the New York Stock Exchange can be counted on to minimize the risk the investor runs on this score.

I hope that I have succeeded in making clear to you my fundamental belief that the problem of management is a crucial problem of the investment company. These companies will stand or fall over a period of time on their ability to perform a useful service to the community and I cannot believe that their usefulness will be enhanced by depriving them of the services and experience of those classes of the American business and financial community which are most experienced in the problems that face investment companies.

Senator WAGNER. Are there any questions of Mr. Bunker? (No response.)

If not, we will hear from Mr. F. Wilder Bellamy, of the National Bond & Share Corporation.

STATEMENT OF F. WILDER BELLAMY, PRESIDENT, NATIONAL BOND & SHARE CORPORATION, NEW YORK, N. Y.

Mr. BELLAMY. I am the president of the National Bond & Share Corporation, a closed-end investment company of the management type, having outstanding but one class of security. I have asked permission to appear before you because our company is small compared with those whose representatives you have heard, and because I am in a position to give you not only the attitude of its management, but also a very good indication of the attitude of the stockholders of this corporation toward this proposed legislation.

My remarks will take less than 10 minutes.

Formed in March 1929 by the New York Stock Exchange firm of Dominick & Dominick, of which I am a partner, and managed by that firm in the succeeding years under a management contract, our corporation has paid cash dividends in every year of its existence since 1929, and as of this date the asset value of each original share is greater than its value upon the formation of the corporation, so that an original investment in this company is represented by assets worth more in April 1940 than they were in March 1929.

My primary duty as president of this corporation is to represent its stockholders, and with that aim in view, and within a few days of the introduction of this bill in the Senate, I forwarded to each of our stockholders a copy of the bill. Because of the length and complicated nature of the bill, I tried to explain to the stockholders in a covering letter the more important effects which it would have on the manage-

ment of their company. That letter, which incidentally contains a mistake since corrected, I have here, if you should care to see it. It makes no recommendation and asks for no action by the stockholders except an indication by them of their attitude toward this proposed legislation.

The National Bond and Share Corporation is a small company. It has 953 stockholders. The management of the corporation to date has received from 21 States 205 replies. Of these replies, of which we estimate 18 came from individuals of close relationship to the directors, 8 expressed approval of the bill, and 197 expressed disapproval of it. The replies are available in the event that members of the committee should care to see or to inspect them. They range from mere expressions of approval or disapproval to long and detailed objections to this proposed legislation.

Senator Wagner. Will you put your letter to the stockholders into the record?

Mr. Bellamy. I will, Senator. I might want to refer to it.

Senator Wagner. All right.

Mr. Bellamy. As president of this corporation, I will welcome any step which really benefits our stockholders, whether this step comes as a result of legislation or whether it comes as a natural evolution in business practice. I want our stockholders to know everything we do, and why we do it, and I want every practical safeguard against acts or policies which may hurt them, but I do not want their expenses to rise, and I do not want them forced against their will to change their management or the character of their company so that they find themselves investors in an enterprise the whole complexion of which has been changed without their consent.

Because other representatives of the industry have appeared and will appear before you, I will limit myself, with your permission, to a discussion of those comparatively few provisions in the bill which most seriously affect our company.

I am sure that our company in its relation to its stockholders and in the effect which this proposed legislation will have upon it must be typical of many others, and for that reason I should like to use it in my remarks as a method of illustration.

The officers and board of directors of the National Bond & Share Corporation since its organization have consisted entirely of members of the firm of Dominick & Dominick, and that firm has acted as its manager and principal broker. This relationship was known to all of the original purchasers of its stock. In fact, I think it fair to say that it was in the first instance, and has continued to be, the principal inducement for the acquisition of the securities of the corporation.

Section 10 prohibits the corporation from having a board of directors of which more than a minority are members of any one firm or are persons who regularly act as its manager or as its broker. Section 10 also prohibits any person who is the regular broker for the corporation from also acting as its manager. The theory of these provisions is apparently based on the hypothesis that one who acts as broker and manager may dishonestly undertake the purchase and sale of securities for the account of the corporation in order to make commissions for himself, and that this temptation is irresistible.

Senator Taft. You say that this is a closed-end company. What other type is there? Diversification? Small lots of all kinds of stock?

Mr. BELLAMY. Yes. The policy is to invest small amounts in readily marketable securities. It is all common stocks.

Senator TAFT. Is there any considerable question at all relating to the matter of control of other companies? That control never did have any particular influence in the management of such a company, did it?

Mr. BELLAMY. No, Senator. This is only a $9,000,000 corporation. The problem presented is of particular importance to a small company such as ours, for the time, trouble, and experience necessary to manage a fund of $9,000,000 are nearly as great as are necessary to manage a fund many times larger, so that while the cost may be approximately the same, the proportion is higher for the smaller fund.

The chief justification for the existence of any management investment company is to enable the investor to obtain adequate diversification of investment and exeprienced management at a cost not disproportionate to the advantages achieved thereby.

There is already a heavy tax burden upon investment companies, and if there is added thereto too great a burden for management expense, the management investment company no longer serves a useful purpose.

Section 10 seems to me to necessitate:

(1) An independent board of directors.

(2) Possibly an independent investment officer or officers.

(3) Brokers who have less than 50 percent representation on the board of directors.

(4) Possibly a manager who has a similarly restricted representation on the board.

Accordingly, our company is confronted with the necessity of employing and paying separately at least two, and possibly three, different groups of persons for the performance of those functions which in the past have been performed by one group alone. It happens in the particular case of the National Bond and Share Corporation that the commissions on the purchase and sale of securities, the amount of which is reported currently to the stockholders, the S. E. C., and the New York Stock Exchange, have been the only compensation paid for all of these services. This is the case because the original management contract provided for compensation so conservative from the standpoint of the stockholder that no payments thereunder have ever become due.

In any event, it is apparent that if the bill in its present form is enacted into law, this corporation cannot carry on without an increase in its expense.

Although I heartily disapprove of the philosophy which condemns a business relationship completely disclosed to, and thoroughly understood and approved by, the respective parties thereto solely because there may exist in any degree therein a "dual relationship," nevertheless, I believe that the election of an appropriate number of independent directors under whose scrutiny and criticism contemplated transactions would pass for review would furnish a desirable protection both for stockholders and management and, in my opinion, would remove any criticism of such so-called dual relationship as may now exist in broker-managed companies.

It has always seemed to me that broker management of a company of this character should be efficient management. The operation of

investment companies in this country is a comparatively new industry, but it involves the kind of knowledge and experience which have been gained by many in the brokerage business over a long period of years. It must be remembered that the brokerage business and members of registered exchanges are at the present time more closely regulated than almost any other group of businessmen in the country.

I think the S. E. C. will agree that the brokerage fraternity as a whole has submitted to regulation by the Commission with a spirit of cooperation and that in the great majority of cases has shown an honest endeavor to comply not only with the letter but with the spirit of the law and the Commission's regulations.

Therefore I completely disapprove the provisions of those portions of section 10 of this bill which provide for what appears to me from a practical point of view to be a segregation of brokerage and managerial functions.

Section 5 and section 13 have a far-reaching effect on the whole industry because they seek to classify security companies by their rate of portfolio turn-over and provide that once a company has fallen into the class of a low turnover company it may not substantially increase its activity without the consent of its stockholders.

Senator TAFT. You mean, in buying and selling securities?

Mr. BELLAMY. Yes, sir.

Senator TAFT. Turning them over faster?

Mr. BELLAMY. Yes, I am not using exact figures, because you get into too many complications if you do.

Under these provisions a low turn-over company which had reached the upper limit of its class's activity, even if suddenly faced by panic or boom conditions, could neither sell nor buy securities without the approval of its stockholders, to be obtained at a meeting for which weeks' notice must be given. This provision appears to me to be an outright danger to investors, not a safeguard.

I think that Judge Healy spoke of some tax advantage which might be recommended for companies having certain characteristics, among them that of low turn-over. This seems to me to add danger for the investor because the directors of a company at the top of the low turn-over limit, believing that either selling or buying was to the advantage of their corporation, would hesitate to act since in addition to the responsibility for the wisdom of the contemplated action they must also take the responsibility for incurring the liability for additional taxes. If the history of the last 15 years has proved anything, it has proved that the practice of allowing investment policy to be governed by tax considerations rather than economic conditions has been disastrous.

If there were any formula for the handling of money which guaranteed success, I think it would be universally in use, but unfortunately there is none. On the contrary, while there are many theories with regard to the handling of money, success or failure depends primarily on the wisdom with which these theories are applied. I am strongly in accord with the principle that the stockholder should know the general policies of the company in which he is an investor, and I am strongly in accord with the principle that the management of his corporation should not go beyond the known scope of its policies without the approval of the stockholders, but I am as strongly opposed to any legislation that limits the activities of management within this

known scope because I know that such legislation is bound to impair the efficiency of management.

I will not speak of the general restrictions upon directors which seem to me to defeat their very purpose and to insure the election to boards of this character of only incompetent directors, nor will I speak of the provisions governing the settlement of lawsuits, the restrictions on dividends, the registration of officers and directors, the enormous amount of data to be filed with the Commission, but I cannot close my remarks without commenting on the tremendous reservation of power to change the rules which would place the industry constantly in the position of not knowing what it could or could not do. These restrictions and provisions, in my opinion, present insurmountable barriers to the successful operation of the kind of a company which I represent.

The stockholders of this corporation are well informed as to its affairs. Many from time to time make close inquiry and learn of our mistakes as well as our successes.

This fact, together with the replies of our stockholders giving their views on this bill, indicates to me that the stockholders of this corporation do not want to be subjected to the provisions of this or any similar bill, that they are at the present time satisfied with their management and that they wish it continued.

There have, however, been flagrant abuses and many mistakes in this industry, and to any reasonable regulation which will make less likely their repetition in the future no reasonable man can object. I am in favor of such legislation if it is simple in form and easy of administration.

I approve of the six points suggested here last week by Mr. Bunker, with which I think the greater part of this industry is in complete accord. A simple, easily administered law containing such provisions, together with the already existing regulation by Federal and local authorities, the liabilities, civil and criminal, to which officers and directors are subject, would accomplish the result of giving adequate protection to stockholders without disrupting an industry which I believe is destined to play an increasingly important part in our national economy.

Senator TAFT. You say you have only one class of stock. What are your views as to the question, not of the importance of changing existing ones, but your future policy with reference to that?

Mr. BELLAMY. Senator, our company was formed really at the request of the clients of our firm. The stock was never publicly offered. There has been some public distribution, but it was sold in the first instance privately to our own clients. This was the kind of a company they wanted, because they wanted us to deal in securities somewhat freely; and for that purpose it is my opinion that a plain common-stock set-up is better. I can see no reason why there should not be many different classes of stock outstanding. For our particular kind of a company this seems most appropriate.

Senator WAGNER. You said in the course of your testimony that you did believe in the election of some independent directors?

Mr. BELLAMY. I do, Senator.

Senator WAGNER. Have you in mind whether there should be a specific minimum of independent directors provided?

Mr. BELLAMY. To put it the other way, Mr. Chairman, I think I should say the maximum. I do not think that a corporation of our

character, Senator, the management of which by us is the principal thing on which the stockholders rely, should be forced, not because of the management but because of the stockholders, to surrender or to allow others to get control of the board of directors. My opinion would be that it would not make much difference what number it was so long as it did not come up to 50 percent.

Senator WAGNER. In other words, in your opinion it should be a minority representation?

Mr. BELLAMY. I cannot see any representation that could be supplied by a majority that could not be supplied by a minority, for, after all, Senator, the cold light of day is the thing that keeps people from doing things that are wrong. As a rule the minority directors can see that the light of publicity, is turned on transactions just as well as the majority can.

Senator WAGNER. However, you do agree that it is desirable to have some independent directors?

Mr. BELLAMY. I do.

Senator WAGNER. These letters are not included in your testimony, so I will put them into the record at the conclusion of your testimony.

Senator FRAZIER. Does your company have some subsidiary interest?

Mr. BELLAMY. Yes.

Senator FRAZIER. Just one company?

Mr. BELLAMY. Yes.

Senator FRAZIER. What do you think of the proposition of having a dozen different companies, as some of them have?

Mr. BELLAMY. I am not really competent to discuss that, Senator. My experience has been, as you see, very limited in the management of a very small company, and I have never given any consideration to any other form of operation.

Senator WAGNER. Thank you, Mr. Bellamy.

(Copies of two letters, dated, respectively, March 27, 1940, and April 9, 1940, from F. Wilder Bellamy to the stockholders of National Bond and Share Corporattin, are here printed in full as follows:)

NATIONAL BOND & SHARE CORPORATION,
New York, N. Y., March 27, 1940.

To the Stockholders of National Bond & Share Corporation:

We feel it our duty to call to your attention the enclosed bill which has been recently introduced in the Senate and in the House of Representatives of the United States to provide among other things for the registration and regulation of investment companies. The bill is long and complicated but because of the effect it will have upon the operation and management of National Bond & Share Corporation, we earnestly request that you study its provisions.

By the terms of the bill all investment companies, their officers and directors, must register with the Securities and Exchange Commission and, among other things, its provisions have to do with the type of securities such companies may issue; their size in terms of total asset value; their capital structure; the declaration of dividends; the extent to which they may own securities of other corporations; the make-up of their boards of directors; their management; their investment policy; their relations with brokers, underwriters, and financial institutions; the purchase for retirement of their outstanding securities and the provisions of their charters, bylaws, and indentures. In addition, and over and above all, the bill provides that the Securities and Exchange Commission, from time to time, may prescribe such rules and regulations within the provisions of the bill as the Commission may deem necessary or appropriate. In other words, in addition to its specific provisions, the bill vests in the Securities and Exchange Commission a continuing supervision not only of the management of investment companies but of substantially every phase of activity in which such companies may engage.

For the information of those who have become stockholders of National Bond & Share Corporation in recent years, the following facts with regard to the corporation are of interest. The corporation now has approximately 950 stockholders of record and after adjusting for the two-for-one split-up in 1938 the presently outstanding capital stock of the corporation consists of 360,000 shares. These shares are duly registered pursuant to the requirements of the Securities Exchange Act of 1934 and are listed on the New York Stock Ecxhange. Since March 1929, when the corporation commenced doing business, it has paid dividends, in cash, equivalent to $8.90 per present share and the liquidating value of its stock as at the date of this letter is approximately $25 per share. This compares, after adjusting for the two-for-one split-up, with $25 per share initially paid in March 1929. The circular prepared in connection with the original sale of the corporation's stock represented that the board of directors would be composed exclusively of the partners (general and special) of the firm of Dominick & Dominick and that such firm would be the managers of the corporation under a contract which had been entered into between the corporation and the firm and set forth the compensation to which that firm would be entitled as managers. In addition to compensation the management contract also provided, among other things, for the payment to Dominick & Dominick of the usual brokerage commissions on the purchase and sale of all securities effected by that firm for the account of the corporation. The compensation payable to Dominick & Dominick as managers was to be computed upon an amount of net profits which has never been realized so that such firm has never received any compensation except what it has earned by way of commissions on the purchase and sale of securities. Furthermore, no compensation has ever been paid to the partners of Dominick & Dominick as the principal officers and directors of the corporation, the only officer of the corporation receiving any compensation being its secretary who has no affiliation with that firm. The amount of brokerage commissions paid to Dominick & Dominick is regularly published in the corporation's semiannual and annual reports.

If the bill referred to is enacted into law in its present form it will affect the management of your corporation in the following manner: Section 10 (a) prohibits the corporation from having a board of directors of which more than a minority are persons who regularly act as its manager or as its broker. Section 10 (d) prohibits any person who is a regular broker for the corporation from also acting as its manager. The practical application of these provisions is that if it is desired to have the firm of Dominick & Dominick continue its connection with the corporation in some capacity, the alternatives with which your corporation will be confronted will be either:

(1) To have partners of the firm of Dominick & Dominick continue to constitute the board of directors and to be the principal officers of the corporation—in which event their firm could neither act regularly as manager of nor as broker for the corporation—and to provide adequate compensation for their services as such; or

(2) To have a board of directors, the majority of whom are independent persons having no affiliation whatsoever with Dominick & Dominick—in which event the minority of the board can consist of partners of that firm—and either

  (a) To enter into a contract of management with Dominick & Dominick on a basis of compensation satisfactory to them and approved by the holders of a majority of the outstanding stock of the corporation; or

  (b) To enter into an agreement whereby Dominick & Dominick undertakes regularly to serve as broker for the corporation—such an agreement being permitted by the terms of the bill if authorized and approved by a majority of the directors of the corporation exclusive of any director who is interested, directly or indirectly, in such agreement.

In any event it is apparent that if the bill in its present form is enacted into law, your corporation cannot carry on without an increase in its overhead as neither the firm of Dominick & Dominick nor any other persons can be expected fairly either (1) to serve as manager of the corporation or (2) to constitute a majority of its board of directors unless adequate compensation is provided for such services.

With reference to the investment policy of investment companies, section 5 (b) classifies such companies into, among others, (a) "diversified investment companies" which are limited in their portfolio turnover (as defined in the bill) to

one and one-half times in any fiscal year and (b) "securities trading companies" on which no such limitation is imposed. During the 11 years which your corporation has been in existence its average annual portfolio turn-over has been 4.07 times, the highest turn-over having been 7.44 times in the fiscal year ended February 28, 1930, and the lowest turn-over having been 2.55 times in the fiscal year ended February 28, 1933. Because of this rate of activity your corporation would be classed in the first instance as a securities trading company but if in any subsequent fiscal year the turn-over of its portfolio was less than one and one-half times, your corporation would automatically be classed thereafter as a diversified investment company and under section 13 (a) of the bill your corporation could not again function as a securities trading company unless such change is authorized by the holders of a majority of its outstanding stock. In a time of unsettled conditions and uncertainties any limitation on your corporation's rate of portfolio turn-over might well be to its definite disadvantage and pending the obtaining of the necessary authority of its stockholders to become again a securities trading company, your corporation might be obliged to conduct its affairs in a way which would be contrary to its best interests.

The Committee on Banking and Currency of the United States Senate, to which this bill has been referred, proposes to have public hearings on its provisions, these hearings to begin on April 2. Because it is probable that one or more officers of your corporation will appear before the Senate committee in this connection, we will greatly appreciate it if you will let us know whether you approve or disapprove of this legislation and in addition it will be particularly helpful if you will give us the benefit of your comments and suggestions. For this purpose, we enclose herewith a stamped return addressed envelope together with a form on which you may express your veiws. Because of the short time which will elapse before these public hearings commence, may we ask that you favor us with your reply as soon as possible.

F. Wilder Bellamy, *President.*

National Bond & Share Corporation,
New York, N. Y., April 9, 1940.

To the Stockholders of
National Bond & Share Corporation:

We wrote you under date of March 27 with reference to the bill now pending before the Senate and the House of Representatives in Washington to provide, among other things, for the registration and regulation of investment companies. In our letter we made the statement that by the terms of the bill the partners of the firm of Dominick & Dominick could continue to constitute the board of directors and be the principal officers of National Bond & Share Corporation but that in such event their firm could act regularly neither as manager of, nor as broker for, the corporation. A further study of the provisions of the bill would seem to indicate that this statement is incorrect and that there are no conditions under which the members of any partnership could constitute a majority of the board of directors of an investment company.

Very truly yours,

F. Wilder Bellamy,
President.

STATEMENT OF RAYMOND D. McGRATH, EXECUTIVE VICE PRESIDENT, GENERAL AMERICAN INVESTORS CO., INC., NEW YORK CITY

Senator Wagner (chairman of the subcommittee). Mr. Raymond McGrath, please.

Mr. McGrath, you are an officer of the General American Investors Co.?

Mr. McGrath. Yes, Senator.

Senator Wagner. We are glad to hear from you.

Mr. McGrath. Thank you, sir.

I am executive vice president of General American Investors Co., Inc. Personally, although I was in the investment banking business for a number of years, I now have no investment banking connections.

Our company is a closed-end investment trust with assets of over \$29,000,000. These assets are represented by a capitalization which consists of bonds, preferred stock, and common stock in the approximate proportions of about 23 percent bonds, 25 percent preferred stock, and 52 percent common stock. That these senior securities are considered good investments is evidenced by the fact that both the bonds and the preferred stock are selling in the market near their call price. Among our senior securities holders are a number of discriminating investors and public institutions. Our common stock has a book value which is higher than the price at which it was originally offered to the public. It is selling at a substantial discount from its asset value in line with the common stocks of all other closed-end investment trusts. This, in my opinion, is due in a large measure to the unequal tax burden on the stockholders of closed-end companies, plus the fact that the industry has been under the cloud of an investigation for more than 4 years. The two banking firms which sponsored my company have maintained a substantial investment in its common stock since its organization.

Senator TAFT. Who were those firms?

Mr. McGRATH. Lehman Bros. and Lazard Freres.

Now I should like to present the record of our management.

Senator HUGHES. Before you do that, would you mind telling me this: You speak of the taxes on closed-end investment companies. Is that a peculiarly heavy burden?

Mr. McGRATH. I think I can show you that it is rather heavy, Senator. I shall go into that in detail.

Now I should like to present the record of our management. The net asset value applicable to the company's outstanding securities, as just stated, was something over \$29,000,000, based on market quotations of the company's portfolio securities as of the close of business December 31, 1939. After making deductions for retirements, the sponsors and the public paid a net amount of approximately \$25,500,000 into the company at the time of its organization 1 or 2 years prior to 1929. In other words, our company today is worth approximately \$3,500,000 more than it started out with. In addition, from its inception it has paid out an aggregate of \$4,428,000 in interest on its debentures and \$6,774,925 in dividends on both classes of its stock. Further, they have either paid out in taxes or reserved for taxes during this same period \$3,235,000.

I don't mention this record in a boastful way and would not take your time in mentioning it at all except there has been such a parade of the horrible examples of our industry before you that I feel, in order to maintain any kind of perspective, you must look at the good with the bad.

I think a company with our record deserves consideration in the drafting of this type of legislation. Yet I should like to point out to you that our company under the proposed bill would, as a practical matter, be legislated out of existence. Why? First, under various provisions of this bill we would, as a practical matter for one reason or another, lose practically all of our directors. Under section 10, investment bankers on our board would have to decide whether to give up the investment banking business or get off our board. There can't be much doubt about what they would do.

Under a different subsection of section 10, any of our directors who are also directors of portfolio companies would have to give up these

directorships or get off our board. If, as an alternative, the corporation determines, as a matter of policy, to dispose of and never again to reinvest in any of the securities of companies of whose boards some of our directors also are members, these directors become subject to all of the reporting requirements which apply under this bill to investment company directors. If these directors stay on our board, they would be required by section 9 to register. This is a requirement for directors that applies only to this business. Also they would have to report quarterly to the other directors on individual purchases and sales of securities of companies purchased and sold by our trust in the same quarter (sec. 30). This is getting pretty far into personal affairs. What would you do under these circumstances? Would you be a director?

Where are we going to turn for competent directors to replace these people who are required to retire? What incentive can we offer outstanding men of affairs to come on our board?

Secondly, from the various sections just quoted, it follows we would be forced, without the consent of our stockholders, to get rid of our management by this legislation just as effectively as though those now in control had sold it. Yet selling control is a practice rather generally criticized; and our banking sponsors, who constitute a majority of our directors and one of whom is president of our company and who is largely responsible for our record, would have to dissociate themselves from our management. Remember, gentlemen, when our securities were sold to the public, this management and sponsorship, which we are now required to eliminate, was one of the things which the investors who bought our securities sought.

Senator WAGNER (chairman of the subcommittee). Mr. McGrath, I think we had better adjourn right at this time until sometime after noon. Everyone seems to be needed on the floor of the Senate.

If it is satisfactory to all the members of the subcommittee, we shall recess at this point until 2:30 this afternoon.

(Thereupon, at 11:55 a. m., a recess was taken until 2:30 p. m. of the same day.)

AFTERNOON SESSION

The subcommittee reconvened at 2:30 p. m., upon the expiration of the recess.

STATEMENT OF RAYMOND D. McGRATH, EXECUTIVE VICE PRESIDENT, GENERAL AMERICAN INVESTORS CO., INC., NEW YORK CITY—Resumed

Senator HUGHES (presiding). The committee will please come to order.

Very well, Mr. McGrath; will you continue?

Mr. McGRATH. Senator, I was telling you about how this legislation, as proposed, would affect our company; and I told you that, first, we would lose practically all our directors; second, by this proposed legislation we would be forced, without the consent of our stockholders, to get rid of our management.

Now I go on from that point. In that connection, the third matter to be considered is that unless we retire our senior securities, regardless of existing charter provisions, we would be forced to accept, pursuant to section 18 (d), whatever redistribution of our

voting rights the S. E. C. might deem to be equitable. At the present time these voting rights represent an agreement between our various classes of security holders. Under this bill what do they have?

Senator HUGHES. Your company has a voting right confined to the common-stock holders?

Mr. McGRATH. No, Senator; the preferred-stock holders have a vote—one vote to a share; but there is much more common stock outstanding than there is preferred stock outstanding.

Instead of a definite agreement, they would be faced with an unpredictable voting situation to be determined by the S. E. C. without their consent. If it was decided to retire our senior securities to avoid this situation, we would be left with a company approximately half its present size, which would result in the doubling of the present operating expenses per dollar of stockholder's investment.

Fourth, section 19 (a) makes it unlawful to declare or pay any dividend other than from "undistributed net income from interest and dividends", unless expressly authorized by the charter or stockholders. If we buy and sell securities at a profit, we cannot pay this out in dividends. Thus, although we have profits, for reasons beyond our control from time to time we may have to default on our preferred or common stock dividends. To date, our preferred stock dividends have an excellent record for continuity. This involves us in a square conflict with the tax law. As this point is somewhat involved, I shall refer to it in more detail later on.

Fifth, assuming that we did not retire our senior securities, we should probably very soon find ourselves under tax disadvantages with other types of closed-end and open-end trusts; for, presumably, the S. E. C. will recommend that diversified management companies have certain tax advantages.

Remember, Senators, that our business, like every other business, is competitive.

As I intend to develop the tax angle at considerable length later, I shall only refer to it here.

To present the problem concerning our company under this bill in another way, if this bill becomes law our stockholders will not know, first, who their directors can or will be; second, what our capitalization can or will be; third, what their voting rights can or will be; fourth, what their dividends can or will be; and fifth, whether our company can afford to stay in business at all.

Do you wonder that we say that a company like ours is being legislated out of business? We favor regulation; but after all we can hardly be expected to cheer for our complete elimination.

With your permission, I should like now to refer to the provisions covering classification of investment companies (sec. 5), restrictions upon change of their investment policies (sec. 13), and limitations of their size (sec. 14). This is a series of provisions which are loosely interrelated and which lend themselves to treatment at one time.

For the moment, let us take section 5 which classifies management of investment companies into a number of categories. The most controversial problems under this heading have to do with the subclassification of so-called "closed-end companies." Of these, our group is representative. I shall, therefore, confine my remarks to these classi-

fications, namely, diversified investment company, securities trading company, and securities finance company.

A "diversified investment company" is one which has no more than 5 percent of its assets invested in any one company and at least 85 percent of the value of its total assets invested in situations in which no individual investment exceeds 5 percent of any class of securities of any other company. Its portfolio turn-over—that is, the ratio during its last fiscal year of the aggregate of its purchases and sales to its total assets—may not have exceeded 150 percent. It may have outstanding only one class of securities other than short-term paper. It may not control any voting security issued by any other investment company.

From the point of view of informing stockholders of the investment policy of a company, this definition of a "diversified investment company" in section 5 is completely misleading.

(At this point, Senator Wagner, chairman of the subcommittee, took his seat at the committee table.)

Mr. McGrath. It is quite obvious that the fact that a company has senior securities outstanding, as our company has, or owns the voting security of another investment company, has nothing whatsoever to do with its investment policy's being diversified. Yet, a company like ours—despite our diversified investment policy—cannot qualify as a diversified company. In other words, we are called what we are not. To my mind this is misleading.

In passing, it is interesting to note that under section 35 (d) it would be illegal to use as part of the name or title of a company anything which, in the light of the business and history of such company, the Commission finds deceptive or misleading. Thus, if we were a diversified company, we could not include the name "trading" in our corporate name. Yet, under section 5, because of its arbitrary provisions, we are forced to masquerade under the misleading classification of a trading company, though we are not.

Senator Wagner asked Mr. Bunker, the other day, if stockholders should not be informed of the fundamental policies, so they would not be misled. I agree they should, but this bill requires us to mislead them as to our investment policy merely because we have senior securities.

A "securities trading company" means any management investment company other than a diversified company which meets the requirements of having no more than 5 percent of its assets in any company and no more than 15 percent of the value of its total assets invested in situations in which its investment exceeds 5 percent of any class of securities of any other company. I have just shown this definition is misleading because it means that a company such as ours with senior securities outstanding would be classified as a "securities trading company" for this reason alone and regardless of its diversified investment policy. In other words, the most important characteristic of a trading company should be its declared policy to trade and exceed a specified turn-over rather than to purchase and hold for investment. A pure trading company may be more speculative than a company like ours. Yet, companies whose turn-over may be way under the 150-percent percentage specified in this bill as characteristic of an investment company are required to classify

themselves as trading companies. If classification is supposed to be informative, is this informative or misleading to stockholders?

A "securities finance company" means any management investment company other than a "diversified investment company" or a "securities trading company." This again would not necessarily mean that a "securities finance company" would be in the kind of a business which the statutory classification indicates. In fact, many semiholding companies will be forced into this category; because by declaring that they did not intend to comply technically, if you will excuse my abbreviation, with the requirements of not more than 5 percent of assets in any one situation and not more than 15 percent of total assets invested in excess of 5 percent of any class of stock—the so-called 5–5–15 diversification requirement discussed above, for "diversified investment companies"—they could still adopt an investment policy that would more closely approximate the policy of a diversified company than the popular conception of a "securities finance company" policy. Even if they adopted a 6–5–15, or a 5–6–15, or a 5–5–16 investment policy, which would disqualify them from being a diversified company, they would still be more of a diversified investment company than a finance company. Presumably, in making these categories the Commission had in mind certain social objectives of protecting investors; but I submit they are unrealistic; for, I ask you gentlemen, is it realistic or informative to stockholders to call a company by a name that the S. E. C. will not tolerate, on the ground that under the Securities Act of 1933 it is misleading to use such a name?

I have discussed the three types of closed-end investment companies set forth in section 5. Now let me discuss somewhat in detail the restrictions on "diversified management companies." We have just seen that in section 5 a "diversified investment company," in addition to the requirement of having not more than 5 percent of its assets invested in a single issuer, may have no more than 15 percent of the value of its total assets invested in situations other than those in which its investment is limited to 5 percent of any class of securities of any other company. In other words, a maximum of 15 percent of a diversified investment company's funds would be available for activities other than investment in a diversified portfolio of marketable securities. Out of this 15 percent, which I shall call the "reservoir," the company may, first, take underwriting commitments under certain restrictions and, second, make less restricted types of investments. That is to say, within the 15 percent it may not invest more than 5 percent of its assets in one company, but may invest in more than 5 percent of a single class of stock of another company. Assuming for purposes of argument that the whole reservoir would in fact be employed in underwriting activities or venture capital activities, a thoroughly arbitrary limitation is thus placed on the total investment company funds available for dynamic use. I feel that to place such a restricted mathematical limitation on future possibilities may be economically unsound. This is simply damming up another possible tributary of the flow of capital into industry. Serious consideration should be given to raising this reservoir to 25 percent.

Another thing that might unduly restrict the reservoir is the method of valuing assets. Suppose a diversified investment trust has assets of $1,000,000: The reservoir may not then exceed $150,000. Sup-

pose it has made an investment of $100,000 in the securities of a young and growing company of which it purchases 6 percent of the common stock: This leaves $50,000 margin in the reservoir. Suppose that investment is successful, so that the value of that stock increases to $160,000, and the Commission requires that it be carried at this figure instead of at cost, as it has the right to do, pursuant to section 45 (a) (29): Then, as long as the company continues to hold that investment, it is forbidden to make any more of such venture-capital investments, because its reservoir has been used up.

On the other hand, if this investment were unsuccessful and its value declined to $50,000, and the investment were valued at market, then the company would still have approximately $100,000 in its reservoir. In other words, the reservoir provision penalizes successful investments by saying, "You cannot do it again," but permits unsuccessful companies to go merrily on. If this provision is to stay in the bill, at least the company should have the right to carry reservoir assets at cost and not at a higher valuation fixed by the Commission.

As a matter of principle, I believe that if one accepts the premise that venture capital is tending to dry up in this country and that its sources should be stimulated, then such narrow restrictions on the amount of such capital available from investment-company sources should not be imposed.

Now, Senators, the last restriction that I want to discuss is a restriction of 5 percent on any class of securities of another company; and I do not wish to make so very much of a point on that. I think that more serious consideration should be given to the limitation whereby a "diversified investment company" may not own more than 5 percent of any class of securities of another company. If the reservoir is made large enough, this need not trouble us greatly; but it should be pointed out that the larger investment trusts are frequently unwilling to make investments small in dollar amount, owing to the difficulty and greater expense of keeping in touch with a large list of small holdings. The prohibition, as mentioned, of investing more than 5 percent in any class of stock of a company could very well mean that the securities of many small but growing industrial companies would be unavailable to the more important investment companies. For example, any purchase of such securities in line with the investment company's general policy might require the purchase of an amount exceeding 5 percent of a class, although only 1 percent of the investment trust's assets. If a company has $1,000,000 of assets, all in common stock, no investment company may hold more than $50,000.

Ten percent has been regarded in a number of other acts as the dividing line between a casual investment and an investment tinged with the power of control. In the interests of greater flexibility, I should suggest that in addition to a larger reservoir than 15 percent, the other assets of a diversified investment company be available to the purchase of holdings of up to 10 percent of the securities of any class of other companies, rather than the 5 percent provided by the bill.

Another characteristic for qualification as a "diversified investment company" is that a company's portfolio turn-over—that is, the ratio of purchases and sales to total assets—during its last fiscal year did not exceed 150 percent of its total assets. The whole idea back of this provision seems to be based on an impractical view

of the problem of managing an investment fund. There are years in which good judgment impels one to make virtually no changes in one's investments. There are other years in which, as I shall refer to later, quickly changing conditions cause one frequently to change one's investment policies.

In a situation where it is necessary to exceed the specific portfolio turn-over in the interest of good management, there would be the following consequences, under the bill as drawn: First, assuming preferential tax treatment—which I shall discuss later— is granted to diversified investment companies, such a company changing to a trading or finance company would lose the advantage of such preferential tax treatment. In other words, if you change from a diversified company to a trading company, then presumably you lose certain tax advantages.

Second, pursuant to section 13 (a), it would be necessary to go to your stockholders in order to change your classification; and, by the time approval was obtained, it might be too late; and, third, if you were registered as a diversified investment company, you would have to classify yourself as a trading company, in which case your size limitation would be reduced from $150,000,000 to $75,000,000, as far as issuance of new securities is concerned. This might be quite a price to pay for the exercise of business judgment.

If the answer to this dilemma were to be to give the Securities and Exchange Commission discretionary power to increase the rate of turnover in special instances, it seems to me that in the final analysis this places the Commission in the position of passing on a matter of business judgment; because changing the rate of turn-over is a matter of business judgment; and time, alone, can prove the correctness of this judgment.

Last Monday Mr. Schenker referred to the fact that the Commission's study of the average turn-over of a great many companies during the years 1933, 1934, and 1935 was used as a yardstick in determining the turn-over limitation for purposes of this bill. If so, this may be misleading. To begin with, while the names of the companies whose turnover was studied are not available to us, it is fair to assume that the list includes a substantial number of large companies. Turn-over, I believe, is usually less in large companies than in small ones. In all probability it also includes a number of companies having substantial proportions of their assets invested in so-called permanent holdings. For example, the Petroleum Corporation was referred to by Mr. Schenker last Wednesday afternoon as having 70 or 80 percent of its assets permanently invested in the Consolidated Oil Co. If the average turn-over of many such companies were included in the companies making up the S. E. C.'s study of turn-over, then their conclusions as to turn-over might become largely meaningless. Furthermore, their conclusions as to turn-over might have to be materially modified if their study included the turn-over policies of companies which could not qualify under this bill as "diversified investment companies."

Today, there is a war going on in Europe, and no one can foresee what it may involve in terms of an investment portfolio turnover. Investment policy cannot be measured mathematically, and to do so will some day injure security holders.

Judging from last week's testimony, the Commission seemed to recognize that the question of turn-over is a troublesome matter, and I do not feel that any concrete suggestion can be made on this matter until it has been the subject of further discussion and consideration. Proper reporting to stockholders should solve this difficulty. In other words, in my opinion turn-over is largely a matter of publicity. If the subject of turn-over is handled by requiring a company to tell the stockholders what the company's investment policy is, then why isn't this object accomplished by, once a year, telling the stockholders what the company's portfolio turn-over has been during that year?

We always have been in sympathy with the view that stockholders should be informed of the fundamental policy to be pursued by their company and should have a definite voice in effecting any fundamental changes in or departures from such policy. Sharp changes in market conditions, however, such as the events of the last few weeks, may force management to act quickly; and the above statement is subject to the proviso that this should not be made so inelastic as to work to the detriment of security holders. For example, even though the management might think sharp changes in the market conditions were so imminent that it was in the stockholders' best interests to sell certain securities and thus exceed a diversified investment company's turnover ratio of 150 percent, nevertheless, without the stockholders' consent, under this bill it could not do so. By the time consent was obtained, it might be too late to act; so that at least in this instance the price for stockholders' consent might be too high.

Under section 13 (b), the S. E. C. is given the power to determine which investment and management policies are fundamental; and this part of the section provides that these may not be changed without the stockholders' consent. We consider unnecessary this wide-open delegation of absolute discretion to the S. E. C. as to what is a fundamental policy, and we believe that such a provision is certain to subject our all-too-uncertain industry to still another element of uncertainty. If this provision remains in the bill, Congress will be vesting in the S. E. C. a degree of control over the internal management of investment trusts, which probably never has been available to any governmental agency in this country. The Commission may not only by "rules and regulations" but by "order" designate what are the fundamental investment policies. The inclusion of the word "order" gives the Commission authority not merely to issue general rules and regulations governing all companies, but gives to it the right specifically to control an individual company with respect to its investment and management policies. In fact, as the bill is drawn, the designation by the Commission of what investment and management policies are fundamental must be with relation to specific companies.

Mr. Schenker stated that the Commission would not object if this provision were eliminated, but that it was thought management would welcome having the S. E. C. determine what are fundamental policies, before submitting these questions to stockholders. This might involve a company in long and expensive hearings before the S. E. C., when time was essential; and in practice it would probably be found that if the management had sufficient doubt to impel it to ask the S. E. C. whether a policy was fundamental, the S. E. C. would

resolve the question in favor of submitting the matter to the stockholders.

The bill should set forth, within well-defined limits, what constitute fundamental policies. If these cannot be drafted in a bill, they probably cannot be drafted in rules and regulations; but if drafted in the bill, then both the stockholders and the directors would know what these policies are. In this manner, the proper purposes of the statute would be served; investor protection would be advanced; directors would know what they could do in the way of management; and management would not be required to sit on the "anxious seat" with other suppliants outside the Commission's door, before they could carry out their functions.

I am not afraid of an S. E. C. ruling on what is obviously a change in fundamental policy. We could easily decide that ourselves and submit it to the stockholders. I am greatly concerned with the misunderstandings, arguments, hearings, litigation, and confusion that could arise over borderline cases.

The provisions with respect to classification of companies, restrictions on turnover, and the reservoir, which I have just discussed, are interwoven in section 14 with the question of size of investment companies. A diversified management company, as far as the issuance of new securities is concerned, can have a maximum size of $150,000,000; but a trading or finance company is limited to $75,000,000.

As regards the classification problem, the matter of size really has nothing in it which is germane, nor is restriction on size necessary for the protection of the investor; yet, companies of different classifications are assigned different size limits. I think that this question of size should be looked at on its own merits. It is clear it does not afford a proper basis of classifying companies. Any limitation on size is putting a premium on incompetence, since it only penalizes those who are able to grow through merit.

As far as I know, the provisions in section 14, limiting maximum size of investment companies, are unprecedented in American law. There is no real proof that a larger company cannot be operated as well as a smaller one. A maximum limit on size probably increases operating expenses per unit of holding. Certain laws of the past, such as those dealing with monopoly, have had the effect of indirectly limiting size. This is the first time that there has been serious legislative advance of the proposition that companies of a certain kind, whose assets exceed a fixed dollar amount, shall be prohibited from further expansion. The dollar is not a fixed unit of value, and adopting a dollar measure may cause serious difficulties. If no size limit is introduced by statute, then it is to be presumed that natural limitations of efficiency would prove a more effective check on size. The idea that a limitation on size will either increase efficiency or solve social problems seems startling.

Section 14 of the bill does not advance any explanation for the proposed size limit. The only argument for it is found as part of the so-called declaration of policy of the bill, contained in section 2. The pertinent language is:

> It is hereby declared that the national public interest and the interest of investors are adversely affected * * * when investment companies * * * attain such great size as to preclude efficient investment management and to have excessive influence on the national economy.

There is no proof of either of such assertions. The limitations on the ratio of single investments to total assets and percentage of a single class of stock that can be purchased should afford adequate public protection against the controlling by trusts of other corporations. This was recognized by the Christian Science Monitor, in an editorial on March 20, 1940, in which it said:

> This top, incidentally, appears to be the expression of another theory, the familiary megalophobic notion that mere size is dangerous. This is curiously the same dollar limit once proposed for life-insurance companies during the Armstrong investigation. Here, however, the door has already been locked against the danger of octopus control by the "five and five" provision in the bill forbidding the trusts to own more than 5 percent of the securities of any one company or have more than 5 percent of their own funds invested in any one company.

This is an example, it seems to me, of one of the faults we find in this bill. In other words, having by the five-and-five provision cured any danger of octopus control, they go and put in the bill another provision, to cover something that has already been cured—in other words, layer on layer.

It is astonishing to us that the conclusions of the S. E. C. in regard to size have not yet received wider public attention. The idea of limitation of maximum size of enterprises, on the hypothesis that an investment company of great size would exercise too potent a social and economic influence, is a frank attempt to crystalize into law a social philosophy which is as startling as it is debatable. We do not feel that it is incumbent upon us to argue this controversial question that by statute those who, through merit, grow in size, consequently become suspect. We repeat that it is startling. We have pointed it out to show that in this bill the provisions limiting size really have nothing whatever to do with the protection of investors. These limitations go far beyond investor protection and enter an uncharted field of social legislation which, if adopted in this instance, may serve as a convenient precedent for the breaking up by Federal law of great American insurance companies, banks, and industrial enterprises. We should stop, look, and listen, before adopting anything so un-American as a measure to penalize success.

I now come to one of the most important matters interrelated with classification. I refer to the problem of the future taxation of investment companies. Although this problem is not mentioned in the bill, it is of such vital importance and is such an inherent part of the whole question of the future existence of the closed-end investment, company that it seems to us it must have a prominent place in the policy of the bill. In fact, the question of tax treatment was mentioned by Judge Healy in his opening statement. I consider it a most important factor in the whole question of regulation. From the way the subclassification of closed-end companies is set up in section 5, it seems reasonable to assume that only the "diversified investment company," as defined in section 5, will be selected for favorable tax treatment. Should such relief be granted, there will obviously be a valuable premium placed on the companies which qualify as "diversified investment companies," and the others will correspondingly suffer.

We believe that the sole purpose of the S. E. C. in devising the classifications in section 5 should have been to provide a basis for future tax treatment. We strongly urge that classification as de-

signed in section 5—which now is confusing to stockholders—be for that sole purpose, and that the class of companies to be afforded this preferred tax treatment be made as broad as possible. This is a question of substance and not merely a question of draftsmanship.

A word of explanation with respect to why this is so is in order. As you have heard again and again, investment companies are particularly adapted to the needs of an investor of small means; but the fact of the matter is that unless the closed-end investment company receives some equitable tax treatment, the man of small means who solves his investment problem by purchasing shares of a closed-end investment company finds himself subjected directly and indirectly to a tax burden far greater than would concern him if he had invested directly for his own account, with all the expense and difficulties such direct investment involves.

Senator Hughes asked a question this morning about the tax burden on a small investor. I think this will answer your question, Senator.

Let us assume that a man of small means pays taxes on his own direct investments in the 4 percent or 5 percent bracket: If he places all his funds in a closed-end investment company it is perfectly obvious that he is subjected, in addition to his individual taxes, to the 18 percent corporation tax, with respect to the interest and capital gains which that company receives in the first instance, plus State franchise taxes, et cetera, and thereafter to further taxation—at whatever tax rate his income requires—as he receives profits or dividends from his investment company. If, for example, this happened to be about 5 percent, it is obvious that he would be paying directly or indirectly 400 to 500 percent of those taxes which would ordinarily be due if he were investing directly for his own account.

Senator HUGHES. Is that 400 or 500 percent?

Mr. McGRATH. It is 18 percent plus 5 percent equals 23 percent, which is somewhere between 400 and 500 percent of 5 percent.

Indeed, this principle was recognized in the 1936 Revenue Act; and relief was accorded to the open-end section of the industry, through section 48 (e) of the revenue act. This same provision was again extended in the 1938 Revenue Act and is applicable to the open-end companies at the present time.

Senator TOWNSEND. When does this second extension expire?

Mr. McGRATH. It is still in effect.

Senator TOWNSEND. Is there any date fixed for that extension?

Mr. McGRATH. The new tax bill.

Senator TOWNSEND. All right.

Mr. McGRATH. However, a very large section of the industry, namely the closed-end type of company, does not enjoy the benefits of any exemption.

Senator WAGNER. I must leave now, to take part in a vote. Senator Hughes and Senator Townsend have paired their votes, and I shall ask Senator Hughes to preside.

(Senator Wagner thereupon left the committee table.)

Senator HUGHES (presiding). Very well, Mr. McGrath, will you please proceed?

Mr. McGRATH. Yes, Senator.

May I say, moreover, that profits arising from realized capital appreciation are defined as "income" in the Revenue Act of 1938

and are taxable. Section 102 of the Revenue Act of 1938 imposes a penalty tax on unreasonable accumulations of surplus. As interpreted by the Treasury Department, this may require a closed-end investment company to pay out in the form of dividends, to its stockholders all the profits, including capital gains, which it realizes in any year, except such portion as it can prove it requires to carry on its business. Consider the dilemma of the closed-end investment company, compelled to comply with the provisions of the Revenue Act of 1938 and with section 19 (a) of this bill; for, although realized capital appreciation constitutes income, under the revenue act, and taxes must be paid thereon and are distributable as dividends to the extent stated, under section 19 (a) a registered investment company may pay dividends only from "undistributed net income from interest and dividends" received, unless expressly authorized to the contrary by its charter or its stockholders.

I am not a tax expert and I do not wish to bore you, but the following must be answered in reconciling section 19 (a) with the revenue act:

What is undistributed net income from interest and dividends? Is it the intent of section 19 (a) that undistributed net income should be computed from the date of inception of a corporation or from the date of the enactment of the bill?

If it is intended that undistributed net income should be computed from the date of the organization of a corporation, the following questions will have to be considered and answered in regard to the method of computation:

First, if during the period since the organization of the corporation, it has incurred security losses in excess of security profits, will it be permissible to charge these losses against undistributed net income from interest and dividends, or will they have to be charged to capital surplus or carried forward as a deficit?

Second, if an investment company is permitted to engage in underwriting, as it is under the proposed bill, it would appear that it should be permitted to take into its undistributed net income, commissions from underwriting, syndicate profits, et cetera, and other miscellaneous income.

If the undistributed net income from interest and dividends has to be determined from the date of organization of a corporation, some apportionment of taxes and expenses will have to be made between such net income and profits and losses on the sale of securities. In some years this would result in practically the entire liability for Federal income taxes being charged against profits on sales of securities, and there would be a relatively small amount of taxes chargeable against undistributed net income from interest and dividends. A considerable portion of the expenses of any investment company consists of research and statistical services which are directed toward obtaining investments which have some possibility of capital appreciation. Consequently, it should be permissible to apportion these expenses to the profits realized on sales of securities.

Incidentally, the bill seems to be drafted on the theory that, henceforth, investment companies should be operated, not with the object of making profits on sales of securities, but with the object of obtaining the best yield on the capital invested. Investing for high yields is a speculative business.

Third, if it is the intention that the undistributed net income from interest and dividends should be computed from the date of organization of the corporation, and there is a deficit therein at the date of enactment of the bill, a company will apparently be bound henceforth by the restrictions imposed under this section, as far as payment of dividends is concerned, until the deficit is eliminated. This would result in penalizing a company for payment of dividends in the past in accordance with the law of the State in which it was incorporated. It is difficult to see how this provision could be of any benefit to security holders.

The bill appears to have been drafted without any particular consideration of the Federal income tax questions involved. These are so involved and intricate that I assume a committee of accountants will explain the conflicts between the law, the Revenue Act of 1938, State franchise tax laws, the excess profits tax, and so forth.

Furthermore, section 19 (b), despite the provisions of section 102 of the revenue act, prohibits an investment company with senior securities outstanding from paying dividends, unless such senior securities have an asset coverage as the Commission may, within the limits in section 19 (b), set forth, prescribe by general rules and regulations, or prescribe by an order applicable to a specific company.

Apart from the actual conflicts between this bill and the tax law, which must be resolved, you must realize that some kind of tax treatment must be anticipated if the closed-end companies are to survive. The basis for this anticipated tax treatment must be outlined in any classification of companies in this bill. Unfortunately, we are not now in a position to discuss this anticipated treatment, because we do not know what tax treatment the S. E. C. will recommend. I do not say this critically, because it is a difficult problem.

If by any chance the S. E. C. had in mind, by the proposed classification, not only laying the groundwork for tax preference but also using tax preference as a weapon to outlaw such other things as capital structure, trust systems, and so forth, we regard this attempted indirect method in this connection as totally inappropriate.

It seems to me that a more accurate classification under section 5 would be to provide for two classes of investment companies—one qualifying for special tax treatment, and the other not—and, as previously suggested, leaving under sections 8 and 13 of the bill the classifications having to do with investment policy.

Now let me turn to another point. It does not seem to me that it is wise to require that stockholders shall select auditors of a company. It has been said at these hearings that the proposal is largely for psychological reasons. I can understand this argument; but I do not think it has sufficient validity to justify the change which, as I understand it, constitutes a direct interference with the fundamental principle of corporate law of most States. As I understand it, this fundamental principle is that the management of the corporation shall be in the hands of its directors and that the directors are to be held responsible for such management. The State laws of incorporation provide for the election of directors by stockholders, and they then provide for the election of officers by the directors. With a very few exceptions, the matter of the selection of auditors is in the hands of the directors. There is no provision in the laws of most States for election of auditors by stockholders.

I realize that this is not a matter of overwhelming importance, because in most instances stockholders will elect the auditors proposed by the directors; and I realize that if the directors who are made responsible for the financial statements do not have confidence in the stockholders' choice, they must resign; but I do not see any reason for distinguishing in this respect between investment companies and any other type of companies, and I do not think that this provision will really accomplish anything. A certified public accountant is a professional man. It is difficult in a proxy statement to compare professional attainments. Whether the auditor is designated by stockholders or by directors, he has a public responsibility in respect of any account which he certifies; and nobody knows that better than a certified public accountant. To my mind, it does not add one bit to his responsibility to have him selected by stockholders, nor would it add one bit to the measure of care which he would employ in performing his duties. I shall not urge the point, but I do want to give you the benefit of my views.

Senator HUGHES. Mr. McGrath, is that based on your thought that whether he is selected by the directors or the stockholders or the officers, he would do his duty anyway along the lines of an accountant; or that if he is instructed by one to do it in a certain way, the others would do it the same?

Mr. MCGRATH. Well, Senator, he is never instructed to do it a certain way; that is, any certified public accountant who will take instructions is no good.

Senator HUGHES. I have heard that before; yes.

Mr. MCGRATH. But, of course, like all professional people, they have made some mistakes—and bad mistakes, too.

Senator HUGHES. Yes.

Mr. MCGRATH. But I do not think the nature of his work would be affected by whether he is elected by an officer or by a stockholder.

Senator HUGHES. And it would contain just as important information for the stockholder, if selected in one way or the other?

Mr. MCGRATH. I think so. As I have said, Senator, I do not think the point is an important one.

Sneator HUGHES. Yes.

Mr. MCGRATH. But what I am afraid of is that some day the stockholders might elect for our company auditors whom I would not like—in whom I have no confidence. Then what would I do?

In conclusion, let me say that our economy badly needs reservoirs of capital with which to purchase equity securities. Thus, the investment trust business plays a most important part in our economy. It is a young and, we hope, a growing industry, born just prior to the panic of 1929. It has suffered acute growing pains and numerous children's diseases. It has not yet reached maturity, and has made numerous mistakes. We plead with you not to kill it off while it is still growing. All economists are agreed that the country needs venture capital and purchasers of equities. Undue restrictions on investment companies may not harm them individually as much as such restrictions may harm the country at large.

In our own company, we know we have done a good job for our investors; and we know that there are many other companies, as mentioned by Mr. Bunker and as represented here, with excellent records. The horrible specimens which have been exhibited to you

are not representative of our industry. No industry, however, can continue to thrive and flourish if public opinion is hostile. If you and the country believe we should be surrounded with all the restrictive provisions of this bill, then we had better go out of business and put our capital to work in other fields, rather than to try to operate under the bill which has been proposed; because we know we cannot operate under it and do a good job for our stockholders.

Senators, do not cram this bill down our throats before we have had ample time to read it, to study it, and to digest it and see its ramifications; and I assure you that these are tasks which I, for one, have not yet been able to perform.

Great strides have been made in investor protection, such as the Securities Act of 1933, the Securities Exchange Act of 1934, the amendments to that act requiring that registration statements under the Securities Act be kept up to date, the amendments to that act giving the S. E. C. power over the over-the-counter market, and the supervision of the National Association of Security Dealers, the Public Utilities Act of 1935, the amendments to the Bankruptcy Act affecting corporation reorganizations in 1938, and the Trust Indenture Act of 1939. All of these acts are new, and they still present great problems.

Do not misunderstand me. We think there should be regulation of the investment-trust industry, along the lines indicated by Mr. Bunker and Mr. Quinn, not only for the protection of the investors but for the protection of the industry itself against unscrupulous elements that might wish to enter it. We hope you will not push us too fast; because under this bill we do not quite know where we are going, and we certainly do not know where we will be if this bill is passed.

Let me recapitulate. I have taken a great deal of your time to say in essence, among other things, the following:

The problem of future tax treatment for closed-end investment trusts is most important.

We urge that the basis for this taxation be laid in this bill.

We urge that you give serious consideration to your treatment of companies with senior capitalization, which we think are most unfairly treated.

We urge that turn-over is a matter of business judgment, and not a matter for this type of legislation. Consider the injury it may do to stockholders.

We urge reconsideration of the restrictions on dividends, in section 19 (a).

We urge that you give careful consideration to the principles involved in limiting size and its correlative features in this bill.

It seems to us that the bill shows evidence of hasty preparation and of failure to give adequate consideration to important and injurious collateral effects which it may have. The bill is too complicated and involved. The powers which it vests in the S. E. C. are far-reaching and, I must say, astonishing.

It has not seemed to me advisable, Mr. Chairman, to repeat what Mr. Bunker and Mr. Quinn have said about its unduly restrictive provisions—provisions which, in our judgment, unduly hamper management without adding to investor protection.

Thank you, gentlemen.

Senator HUGHES (presiding). I understood Mr. Bunker to say this morning that you had not had an opportunity, and the S. E. C. had not given you adequate opportunity to confer with them as to the wording of the bill?

Mr. MCGRATH. Mr. Bunker covered that pretty well this morning. I concur in what Mr. Bunker said on that subject.

Mr. BUNKER. I might add, Senator, that we are all parties in the same group. The memorandum not only covers myself but the other members of my group.

(Senator Wagner resumed the chair.)

Senator WAGNER (chairman of the subcommittee). I think Mr. Quinn is to go on next.

STATEMENT OF CYRIL J. C. QUINN, VICE PRESIDENT, TRI-CONTINENTAL CORPORATION AND PARTNER OF J. & W. SELIGMAN & CO., NEW YORK CITY—Resumed

Mr. QUINN. Mr. Chairman, in my statement on Friday I said that the proposed bill contained a provision so novel, radical and important that, with your permission, we wished to discuss it at greater length.

I refer to section 18 which provides that, in the future, an investment company can have one and only one type of security, a common stock. Bonds and preferred stocks are to be legislated out of future existence, as far as investment companies are concerned.

What reason is there for throwing overboard the precedent of the British and Scottish companies, which have a long and creditable record and experience?

What argument is there for thus limiting any possible future individual choice on the part of investors?

What is the justification for asking Congress to legislate far beyond truth in securities but, in effect, to dictate future style in securities?

One must go for the answer to the declaration of policy in this bill, and to the testimony presented at these hearings. One would expect to find in the declaration of policy some statement of the reason for this radical provision, some explanation of the necessity for thus restricting the personal choice of individual investors.

The references in the declaration of policy bearing on this point are the following:

(1) Paragraph 3 says that when an investment company issues securities containing inequitable, discriminatory, or anomalous provisions or fails to protect the privileges of their outstanding securities the national public interest and the interest of investors are adversely affected.

(2) Paragraph 4 says that when the control or management of an investment company is unduly concentrated, inequitably distributed, or irresponsibly held it adversely affects the public interest.

(3) Paragraph 7 of the statement of policy says that when a company by the borrowing or issuance of senior securities increases the speculative character of their junior securities, the public interest is adversely affected.

Where in any of these sections is there any characterization of investment company senior securities which can be differentiated in the slightest from the senior securities of any other form of American business? If inequitable provisions of securities are bad, they are bad wherever they occur, and not only in investment companies. If con-

trol or management is irresponsibly held it can be just as bad for an industrial company as for an investment company. No one disputes the fact that borrowing and issuance of senior securities may tend to increase the speculative character of junior securities, but how in the world can this be said to apply to investment companies any more than to any business?

Isn't this just parrotting the obvious? Isn't it just saying that if, in the capital set-up of any business, there is present a class of security having priority in earnings and dividends over another, the junior stock is junior to the senior security? But is this more true in an investment company than in any other form of American business?

The existence of senior securities has nothing to do with whether or not the funds you have to invest will profit or lose. The existence of senior securities only means that losses and gains will be shared in different, but well understood and agreed proportions. The existence of senior securities may not even increase the speculative character of junior securities. If I borrow money or sell preferred stock and keep the proceeds in cash or government securities or securities which do not go down, I certainly have not increased the speculative character of junior securities.

I can however follow the future provisions of this bill and set up a common-stock company but I can go out and invest the funds I have raised in highly speculative securities and arrive at as speculative an investment company security as you wish. In other words, the way a portfolio of funds is handled can do as much if not more to make a security speculative than the existence of any reasonable amount of senior securities.

In the declaration of policy and in the discussion of section 18 here there has been no single important reason adduced regarding senior securities in an investment company which cannot with equal force and equal validity be applied to all companies in all businesses.

The important question is thus squarely posed. Is Congress prepared to say that there is something so intrinsically wrong with senior securities generally that their future issuance should be prohibited? Is Congress prepared to say that speculation should be legislated out of existence? Is Congress prepared to say that regardless of the fact that the investor is fully informed of what he is buying, Congress is going to tell him what is best for him?

I doubt if this is wise governmental policy, because, once you embark on this road, where is the logical stopping place? There isn't any. Why start on this dangerous course by making the investment company the guinea pig for a new and novel theory regarding the investment of capital?

I would now like to turn to the testimony presented in these hearings on the subject of senior securities of investment companies. Let me analyze and comment on what has been said. They started out by saying that the senior securities of an investment company are in many ways comparable to a fourth or fifth mortgage. Such a statement applied to the senior securities of investment companies generally is misleading. I don't know exactly what they mean. The example they gave of a senior security several times removed from underlying assets may have something to do with the argument over pyramiding but has nothing to do with a discussion of senior securities as such.

The next argument that they advance in favor of abolishing senior

securities in the future is that there are arrearages in senior securities outstanding in investment companies, and some of them are under water. That is, the assets of the company are not equal to the par amount of senior obligations outstanding.

I haven't seen their detailed figures and I therefore can't comment on them. I could go into a long discussion of the performance of investment company senior securities. I could relate this as it should be related, for proper perspective, to the performance of other senior securities in the same period. But this doesn't seem to me to have much to do with the question under discussion.

What is the relevance of the argument? Are railroad bonds to be legislated out of future existence because a substantial portion of the outstanding bonds of railroads are in default? Are preferred stocks of industrial companies to be washed out in the future because during the depression a great many of them passed their dividends and have since failed to make them up?

I am not disputing the fact that the senior securities of some investment companies got into trouble. This was a fate shared by many other senior securities of many other American enterprises since 1929. But to use this as the basis for deciding that in the future there shall be no more senior securities in American investment companies seems to me both illogical and unsound.

One extraordinary statement was made in this same connection which I would like to take up at this point.

They said that the whole proposal of senior securities in investment securities is rather academic because no company could sell preferred stock now, and you can buy—I quote the testimony:

> the preferred stocks of some of the most reputable companies at 50 cents on the dollar.

I rather resent that description, because that rules some of my friends out of reputable companies, because if you want to buy Tri-Continental preferred you have to pay 81. If you want to buy United States and Foreign preferred you would have to pay 93. If you want to buy Capital Administration preferred, you would have to pay 95, and, as Mr. McGrath pointed out, if you want to buy General American preferred you would have to pay 103½.

There was another statement which was made at that time, and that was that the senior securities of investment companies have never been able to earn their keep. Mr. Smith in this connection quoted from their voluminous report saying "that since 1871 they figured out that the greatest amount common stocks could pay would be 4 percent, assuming a 2-percent capital gain."

I think the stenographer must have gotten Mr. Smith wrong, because I have read that report, and it states that in that period the average yield was 4½ percent, not including an average annual capital gain of 2 percent.

I don't want to bother you gentlemen with an analysis of that section of the report. It may be theoretically right, although I doubt it. Practically it is full of holes.

They don't say that a common stock can only earn 4½ percent. That isn't what the report says. It says that dividends have averaged 4½ percent on the average value of common stocks. Let us see what this means. I buy a share of Du Pont at $100 and it pays $4.50 in dividends. That is a 4½ percent return on that price. But

suppose I hold on to the stock and the earnings increase, so that I get $7 a share in dividends. To my mind, untutored though it may be, the money I have invested is then yielding me 7 percent; but in the S. E. C. study they say, No; that isn't true. The stock has advanced in price to 155, and therefore your yield is only 4½ percent on the then price of the stock.

Now, that may be academically interesting to the statistician, but from the point of view of the man handling funds he would say I am making 7 percent on the money which I invested, and no amount of statistical rigmarole will convince me to the contrary.

Gentlemen, I think that the suggestion that you should legislate senior securities out of existence on the basis of any statistical formula just does not make sense.

In the testimony it was also brought out that the existence of senior securities had permitted and facilitated the transfer of control and thus brought about abuses.

Here you have another example of the piling of one remedy on top of another. They put in the bill one provision which prevents the change of directors without stockholders' action. This is a sound provision and they admit that it would have stopped many of the abuses they cited.

Next, they put in a provision saying that management contracts cannot be assigned without consent of the stockholders. That is directed to the same point of changing management without the stockholders' knowledge or consent.

Next, they put in that no change of policy can be made without the consent of the shareholders. That is sound. But that isn't enough. Having set up three specific cures, they then go to the extreme of saying, although the existence of senior securities has contributed only incidentally to the abuses of the past, "Let's wipe them out in the future."

If anything further is needed to augment the remedies already in the act, surely it could be provided by some provision less drastic than the future abolition of senior securities.

They next say that senior securities make for complication and lack of clarity in reports. Personally, I don't see or believe that. The method of handling accounts which I suggested on Friday would, to my mind, make the position of every class of securities clear to the shareholders. And don't forget, gentlemen, that an investment company's statement is the clearest and most easily understood of statements. Few other forms of American business permit statements of such clarity and simplicity.

They next say that they want to eliminate senior securities in the future because there is an inherent conflict of interest between the junior security holders and the senior security holders. Of course the interests of the senior security holders are not identical with those of the junior security holders. That's why they spell out these respective rights and privileges in a contract. But in what respect, gentlemen, is this different from senior securities generally in any business?

Of course the senior securities want steadiness and continuity of income and all junior security holders want as big dividends as they can get. But these desires are not conflicting; both classes of security holders want their company to prosper.

There is no more reason on this score for legislating senior securities of investment companies out of future existence than there is in

doing exactly the same thing to the senior securities of any American business.

And now let me come to two other arguments that have been advanced. They say that the securities of the investment company should only be common stock like banks and insurance companies. They say they have no senior securities outstanding. This is, in my opinion, technically true, but I think it only tells half the story; it is only a half truth.

Look at an investment company balance sheet and you will see on the liability side the bonds outstanding, the bank loans if there are any, and the preferred stock and the common stock. They are shown as liabilities of the investment company. The bank loans have a fixed maturity; the bonds have a fixed maturity; but the preferred stock has no maturity.

Look at the balance sheet of a bank, and what do you see on the liability side? You see demand deposits in a ratio to junior capital which is infinitely larger than in any investment company. I say that that is just as much senior money as the bonds and preferred stocks of an investment company, but there is one radical difference. The senior money contributed by the depositors must be repaid, and must be repaid on demand.

Take an insurance company and you have an analogous situation. You have the present and potential claims of policyholders which must be met when they fall due, and nobody knows when they will fall due.

To compare investment companies with banks and insurance companies to my mind simply doesn't make sense. They are three different kinds of animals. They say that an investment company ought to be a mutual enterprise. Now this word "mutual" appears in their report but I must confess that I don't understand exactly what it means. The report reiterates the belief that there is a conflict of interest between the different types of securities, imposing conflicting duties on management because the risks, losses, and gains are not equally distributed In what respect is this different from any senior security in any enterprise? To be logical you would have to extend this principle to every form of American business. What is so essentially vicious about a group of investors pooling their money for the purpose of diversifying risks with one group deciding to participate in income and assets on one basis and another group on another? Each interest profits if the investment enterprise is successful. Each interest suffers if it is unsuccessful.

You don't try to solve this possible conflict in other businesses by eliminating all but one group of security holders. It s left to responsible management to work out.

I have been a director of companies with more than one class of securities over a considerable number of years, good times and bad, though in retrospect I must say that they seem to be mostly bad, and I must confess that I have not found any irreconcilable conflict of interest in the existence of more than one class of security.

You do the very best you can even though the results may be disappointing to you. You consider the rights of both classes of security holders just as management of any business does. You try to handle your affairs in such a way that the best interest of both classes will be served without discriminating in favor of one and against the other. I think, gentlemen, that if you try to legislate

possible so-called conflicts of interest out of life you are entering upon an impossible and futile task.

I would like to end this part of my discussion regarding mutuality of investment companies by quoting from one section of the S. E. C. report. The report reads:

> Thus the function of supplying a single investment security which effectively combines the dual qualities of safety and possibility of substantial profit is not served by the multiple securities investment companies which divorce these two objectives.

I frankly don't know what this means, and it is not, therefore, very helpful to me in understanding their argument about mutuality. It sounds uncommonly like the old story of the investor whose modest requirements included 6 percent return, absolute safety of principal and about a 50-percent profit.

Certainly the S. E. C. cannot pretend to argue that their proposed common stock set-up will guard against losses. Bad management or bad times will always cause losses. But to the S. E. C. there is apparently something sacred in sharing these losses equally and not in proportions agreed upon in advance by various types of security holders.

And now I come to the concluding argument used by Mr. Schenker in justifying the future abolition of senior securities. I would like to quote the testimony:

> Now if I may be a little slangy about it, we don't think it is worth the fuss to draw an elaborate provision which probably would be, page by page, to provide for the situation where a company may want at some subsequent date to issue a little preferred stock.

This is a strange argument, in my opinion, in view of the 104 pages of the present bill and the complexity of some of its provisions.

I have attempted to deal with the testimony on capital structures as presented to this committee.

Now I would like to take the other side.

The S. E. C. admits that the diversification of risks achieved through an investment company is a very desirable element of safety for the small investor.

Now, you and I know many investors who are looking for that diversification of risk but who, because of their own needs or wishes, don't want or can't buy common stocks. They need or want the stability and regularity of income and they need the protection of principal embodied in a senior security. The senior securities of investment companies can and have supplied this need. Of course there have been fatalities and of course there have been senior securities of investment companies which haven't lived up to the expectations of the purchasers; but no one tries to legislate on the basis of what Mr. Bunker has rightly pointed out to be samples of the worst. One doesn't legislate all savings banks out of existence because some of them have failed with losses to their depositors.

If you really feel that the investment company has a proper place in the American system, leave a place in the future for those investors, and there are many of them, who do not want the risk of fluctuating and variable income of common stock. Let him diversify his risk in the form he wants it. Make sure that if he is sold a senior security he knows what he is getting. If you think wise, require certain protective provisions in future issues of senior securities. That, to my

mind, is the proper approach. It seems to me poor policy, however, to go to the length proposed in this bill and tell the investor what he can and should buy, override his own personal needs or desires, and legislate any individual choice out of future existence.

I would like to end my comment on this provision of the bill by asking how one would explain this drastic departure in security legislation to an investor who was a satisfied holder of a good senior security of an investment company. I imagine the conversation would go something like this on his part:

I bought the bonds of the X Investment Co. and the preferred stock of the Y Investment Co. I certainly wasn't misled into thinking that they were high-grade securities, but I must say that they have been as satisfactory a holding for me over the last 10 years as my high-grade security. In my high-grade bonds I have been continually having my income reduced and I am certain that when the money rates change I am going to see a pretty substantial decline in capital value.

Only the other day one of the companies offered to buy back some of its preferred stock and called for tenders. Their stockholders must feel pretty much the same way I do. I noticed they only got about half the stock they wanted.

Of course I know that not all of the holders of senior securities of investment companies have had an equally satisfactory experience. I don't see, though, what that has to do with it. Why destroy something that has turned out bo be good for me and some others just because it has been unsatisfactory for somebody else?

I know that certain investment companies and their managements have done things which were not right, but I don't happen to have held the securities of those companies. It doesn't seem sensible to me to try to cure cases of dishonesty by abolishing senior securities in the future. That somehow sounds funny. It sounds as though the people who were proposing it hadn't been able to figure out a proper way to sensibly regulate the business.

They tell me that some senior securities of investment companies didn't do well. I'm not surprised, seeing what happened to most securities. But mine did. I don't see, though, again, what that has to do with the question.

If you once begin to legislate senior securities out of existence, where do you stop? I don't see any difference between saying that an investment company can't have a senior security and saying that a steel company can't have a senior security. They both have their ups and downs. They both do well in good times and do badly in poor times. That doesn't sound to me like a sensible argument for abolishing senior securities of investment companies. If there's anything to the argument, it's an argument for wiping out all senior securities.

I am not interested in buying common stocks. I'll buy them indirectly through an investment company because I get a spread of my risks. But I need a constant and steady income. I can't afford to have my income fluctuate the way a common-stock investment will inevitably do. I am retired and I want to count on a certain amount of income.

Now, it seems to me that if they're hell bent on going that far in legislation, instead of saying that you can't have any senior securities in an investment company the best way would be to say that investment-company senior securities in the future can only be issued under certain restrictions. The restrictions around the securities I bought were apparently satisfactory because my experience has been a good one. Why don't they just adopt those and make all companies do that?

I think, gentlemen, that if you tried to explain the abolition of senior securities to a gentleman who has had that experience, you would have a rather difficult task.

I should now like to turn to another important phase of this discussion. In testifying regarding this section, it was repeatedly stated that this ban on senior securities applied only to the future—that no existing situations would be disturbed. I cannot agree with this statement, and I should like to explain the basis for my disagreement. I shall therefore run rapidly over those parts of the present bill which touch existing capital structure, in many cases vitally.

Section 5 classifies investment companies. It starts out by defining a "diversified investment company." A mere example makes clear what I mean. The classification of a diversified investment company would exclude a company which had then a small amount of senior securities outstanding and regardless of its investment policy it could not qualify as a diversified investment company. I think you will agree with me that being a "diversified" company may have something very important to do with future tax treatment.

Not only are senior securities to be legislated out of future existence but their existence in the capital structure of any company may penalize that company in future tax treatment.

If one turns to section 14 one finds that the bill provides another immediate handicap on investment companies having senior securities.

If a company is a diversified investment company its size is restricted to $150,000,000. I can have exactly the same kind of company as the so-called diversified company under this definition; I can have exactly the same portfolio, exactly the same kind of management, exactly the same kind of successful running of it, but if I have a small amount of senior securities out, my size is not $150,000,000, but $75,000,000.

Section 18 of the bill is that section which forbids the future issuance of senior securities. That part of the section is a clear and understandable statement of future policy, but it contains two subsections which have important present effects.

Section 18 (c) says that it shall be unlawful for any investment company in the future to issue any warrant except a short time right to subscribe. This sounds simple and is a logical accompaniment of their proposed ban on all securities other than common stock. But some investment companies have outstanding warrants which give the holders the right to subscribe in the future to common stock at set prices. And that is a regular feature of any warrant.

The future value of these warrants, therefore, depends to a great extent on the fact that a holder has the right to purchase the stock of an investment company at a fixed price regardless of what may be its liquidating value or market price when he chooses to exercise that right. If he has the right to subscribe for stock at $10 a share and the liquidating value of stock has increased to $20 a share, this measures the arithmetic worth of the warrant to him. It may be a very valuable right for which he has paid money. It may be a right for which he has paid money which he hopes will be of future value to him.

What becomes of these rights, however, when one turns to section 23 (a) of the bill and reads that no registered closed-end management company shall issue or sell any security in contravention of such rules and regulations or orders as the Commission may prescribe to prevent or limit such issuance or sale at a price below the current asset value. Under the act as written the value of the outstanding warrants of an investment company can be worth exactly what the S. E. C. makes up its mind to make them worth. They can be worth what the man honestly thought they were when he bought them or they can be valueless.

If you read on to paragraph (d) of that section of the bill which limits future securities of investment companies to the single classification of common stock, you read that extraordinary provision which

I have already referred to in these hearings giving the S. E. C. the right to redistribute the voting rights and privileges of outstanding securities. I think that you will agree that these two paragraphs alone are a considerable departure from the stated policy of the sponsors of this bill to leave existing situations alone.

Section 19 of the proposed act again touches the subject of senior securities by setting out future restrictions on the declaration of dividends of investment companies. I have already dealt with this section in my testimony of the other day and will not repeat my comments except to point out that here is another place where the bill definitely touches outstanding securities of an investment company and touches them in a most vital and very important way.

Section 21 again comes in and touches present outstanding senior securities. It covers the question of loans by an investment company and provides that it shall be unlawful in the future for any registered management company to borrow money from a bank or other persons except for temporary purposes, and in an amount not exceeding 5 percent of the value of the company's total assets. This sounds as though it banned future bank loans, but gave the companies the right to renew them up to July 1, 1945, which is one of the provisions of that section. This section, however, goes a great deal further. It means that any bond or debenture of an investment company which may mature after July 1, 1945, can never be extended or renewed. However well covered by assets or earnings this obligation of an investment company may be, the company has no option in the future other than to repay it at maturity. The holder is deprived, however satisfactory the investment may be, of accepting either an exchange offering or a new security of similar type.

Section 25 deals with reorganizations and recapitalizations. As I stated in my testimony of the other day, it gives the S. E. C. more authority over the reorganization of solvent companies than they presently have over the reorganization of insolvent companies under the Chandler Act. You may well ask why this has anything to do with senior securities. Let me point out to you that a company having senior securities and desiring to simplify its structure or merge with another company can only do so with the permission of the S. E. C. Under the law as proposed they could not issue anything but common stock, except with the permission of the Commission. But the S. E. C. under the section I am discussing could exempt the company from that provision if it so wishes. But they have the decision in their hands. Even if the stockholders are unanimous in their wish to go forward with a plan of reorganization or merger, they are powerless to effectuate their mutual desires and wishes unless and until they receive the blessing of the Commission.

I have dealt with these various sections of the bill which affect senior securities to make clear that this bill includes not merely a ban on the issuance of senior securities in the future. It touches existing situations, and touches them with a heavy hand. Existing rights can, if the Commission so wishes, be scuttled, and existing privileges of senior and junior securities can be set aside by the Commission if it so desires.

It is true that the present bill does not contain a clear-cut death sentence on outstanding senior securities. It does contain, however, real possibilities of slow strangulation.

Now, Mr. Chairman, we have come to the end of our presentation. Through your kindness we have tried to present an over-all picture of the bill. We have dealt only with the more important questions, because the minutia of the bill is too difficult to deal with at length. We have tried to be helpful; we have tried to give you our views of the bill as we, being men with some practical experience in running these companies, see it. I hope that we have been helpful. I hope we have succeeded in impressing you with the soundness of our views. But whether we have succeeded or failed, we are deeply obliged to you, Mr. Chairman, and to the other members of the committee, for your courtesy and your consideration.

Senator WAGNER. Thank you very much. Your presentation of course has been helpful.

We will begin tomorrow at 10:30 a. m. with the open-end companies.

(Whereupon, at 4:25 p. m., the subcommittee adjourned until tomorrow, Tuesday, April 16, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

TUESDAY, APRIL 16, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, Downey, Townsend, and Taft.

Present also: Senators Adams and Danaher.

Senator Wagner. The subcommittee will come to order. Mr. Traylor?

Mr. Traylor. My name is Mahlon E. Traylor.

Senator Wagner. You represent the Massachusetts Distributors, or at least you are an officer of it, are you?

Mr. Traylor. Yes, sir.

Senator Wagner. We will be glad to hear you. You may proceed.

STATEMENT OF MAHLON E. TRAYLOR, PRESIDENT, MASSACHUSETTS DISTRIBUTORS, INC., OF BOSTON, BOSTON, MASS.

Mr. Traylor. My name is Mahlon E. Traylor. I have been continuously affiliated with the investment trust business for the past 17 years. I am president of Massachusetts Distributors, Inc., of Boston, an organization engaged in the wholesale distribution of the shares of three open-end trusts, namely, Massachusetts Investors Trust, Boston Fund, Inc., and Supervised Shares, Inc. In the past 5 years, the company of which I am head has executed purchase and sales orders for more than $150,000,000 of the shares of these open-end management trusts.

The section of the industry for which I speak comprises the companies known as open-end management trusts, with redeemable shares. The purpose of my statement is to make clear to the members of this committee the present position and past record of these open-end management trusts, and to state in general terms the attitude of a representative group of such companies toward the Wagner-Lea bill.

Most of the testimony you have heard from S. E. C. witnesses in the past 2 weeks dealt with such lurid examples of mismanagement and dishonesty that it might easily have created the impression that such actions were typical of the entire investment trust business. In this connection, we want you to know, Mr. Chairman, that we have appreciated greatly the pains that you and the members of your

committee have taken to remind such witnesses that there were, after all, a great many honest and capably conducted investment companies.

What the open-end trusts are: Diversified investment companies in the United States may be divided roughly into two general types:

1. So-called closed trusts, which have fixed capitalizations and do not sell new shares. Many companies of this type have senior securities; that is, bonds or preferred stock, as well as common stock, outstanding.

2. So-called open-end trusts, whose holders are entitled to redeem their shares at any time at approximate liquidating value. These trusts customarily sell new shares on a continuing basis to replace old shares redeemed and to increase the amount of their funds. Virtually all open-end trusts limit capitalization to common stock only.

The following comparison shows the relative importance of diversified management open-end trusts and closed diversified management trusts, as of December 31, 1939. The companies included have been taken from classifications as shown in Moody's Bank and Insurance Manual. The figures given for closed trusts include only those that maintain diversified portfolios. Holding companies have been excluded:

	Combined assets
Closed trusts, with senior capital	$517, 000, 000
Closed trusts, without senior capital	180, 000, 000
Open-end trusts	554, 000, 000

A list of companies included in the above totals will be furnished upon request.

Open-end trusts are true investment vehicles, designed to give the small investor a well diversified investment with supervision by qualified management.

Senator TOWNSEND. Do you mean that those are the trusts that you are representing?

Mr. TRAYLOR. The figures $554,000,000; yes, sir.

Senator TOWNSEND. Would you care to put in the record a list of them?

Mr. TRAYLOR. I will furnish a list later.

Senator TOWNSEND. All right.

Mr. TRAYLOR. For this reason, they are frequently referred to by the Treasury Department as mutual funds, and most of them receive special tax exemption under the revenue act because they qualify as such under the tax laws.

Open-end trusts that qualify under the revenue act do not invest more than 5 percent of their funds in the securities of any one company, nor can any such fund hold more than 10 percent of the outstanding stock of any one company.

Trusts of this type have enjoyed their greatest growth since the passage of the Securities Act of 1933, and most of their outstanding capitalization has been issued in accordance with the full disclosures required by that act. Although some years ago they comprised only a small segment of the investment trust business, they are now a highly important factor in it.

How the open-end trusts operate: Open-end trusts, when they are incorporated companies, operate under the supervision of a board of directors. When such trusts are voluntary associations, instead of corporations, they are managed by one or more trustees.

Funds are invested in a diversified list of securities—in many cases principally common stocks—which are kept under constant supervision by the management. Securities may be bought and sold whenever the management deems advisable. The objective is not speculative profits, but satisfactory long-term investment results. Securities owned by the trusts are held by an independent custodian—usually a bank or trust company. There are usually restrictions against borrowing, trading on margin, and short selling.

The managements of open-end trusts usually continue without change, and shareholders purchase their participations because of their knowledge of, and confidence in, a particular management group. Open-end companies are unlike any other type of investment company, principally because of the highly important distinguishing feature that their shareholders can, by contract right, withdraw their proportionate interest at will simply by surrendering their shares to the company for redemption at liquidating value. Thus, in the event of dissatisfaction with the management or for any other reason, shareholders always have the right to withdraw—just as the maker of a voluntary trust can reserve the right to withdraw his trust from a bank or trust company if he is not satisfied with the way his funds are being handled. This right to withdraw may also be likened to the right which wealthy investors reserve in placing their funds under the discretionary management of an investment counselor. The threat of withdrawals in case of bad management is the best incentive there can be to good management.

The managements of open-end trusts are compensated on a fee basis. The usual fee is one-half of 1 percent annually of the asset value of the fund.

Senator TAFT. What is the legal status of these funds? Does it mean that any and every stockholder can withdraw?

Mr. TRAYLOR. That is right.

Senator TAFT. Is he in fact a stockholder?

Mr. TRAYLOR. Yes; he is a stockholder.

Senator TAFT. And it is a corporation.

Mr. TRAYLOR. I should add, except in the case of a trust where he is a shareholder of a beneficial interest.

Senator TAFT. Can you do that with a corporation?

Mr. TRAYLOR. They own the trust, and under the laws of Massachusetts they all have equal rights the same as in a corporation. They can liquidate at the liquidating value at any time they care to, sometimes within 2, 5, or 7 days, but in most cases the policy is to give them their money within 24 hours after they deposit their stock.

Senator TAFT. But this withdrawal feature would not apply to every case, would it?

Mr. TRAYLOR. They are set up with that contract right. That has been one of the principal things in the open-end industry, starting in 1924. The shareholder always has the right to get his money out at liquidating value, whatever that may be, at any time.

Senator HERRING. Does he have a vote in the conduct of the business?

Mr. TRAYLOR. Yes, unless it is a voting trust. In the case of Massachusetts trusts he does not have the voting right because those trusts are managed by trustees.

Senator WAGNER. And the trustees are usually banks?

Mr. TRAYLOR. No. They are individual trustees.

Senator WAGNER. You say they are individual trustees?

Mr. TRAYLOR. Yes, sir.

Senator WAGNER. This is a sort of right of redemption, is it?

Mr. TRAYLOR. Yes; and the liquidating value is arrived at every day.

Senator TAFT. At the market value of the stock?

Mr. TRAYLOR. Yes, sir.

Senator WAGNER. What happens if the value of the stocks in the portfolio is fixed in the morning and there is a change in price?

Mr. TRAYLOR. They fluctuate.

Senator WAGNER. Suppose they go up, do the prices go up with them?

Mr. TRAYLOR. At the end of the day a new price is determined based on the closing prices of the securities.

Senator WAGNER. In that connection I was going to ask you about some testimony we have had here, whether that is widespread or whether it is unusual.

Mr. TRAYLOR. That varies. I expect to cover that subject later on, Mr. Chairman.

Senator WAGNER. Are you going to speak about that during your appearance here?

Mr. TRAYLOR. I expect to cover that subject in more detail a little later on.

Senator WAGNER. All right. I will wait for that.

Senator HERRING. Do you know of any open-end trusts that do not have voting trusts; I mean, any company that does not have a voting trust?

Mr. TRAYLOR. Very few have voting trusts.

Senator HERRING. You say very few have voting trusts?

Mr. TRAYLOR. Yes, sir.

Senator HERRING. All right.

Senator WAGNER (chairman of the subcommittee). You may proceed with your statement.

Mr. TRAYLOR. From this fee, however, the managers have to pay important expenses of administration, such as rent and the cost of adequate research and clerical facilities. Occasionally, management compensation comprises 5 or 6 percent of the annual investment income of the fund instead of a fee based on the value of assets. Such fees based on income correspond to the charges made by trust companies for continuing service as trustees under testamentary trusts in Massachusetts where this type of investment trust was; first started. When fees are 5 or 6 percent of income, as this rate is materially lower than one-half percent of assets, the fee is net, that is, the administrative expenses described above are charged to the trust in addition.

Open-end trusts sell their shares on a continuing basis, to replace shares redeemed and to increase the size of the trust, just as life-insurance companies and savings banks continually solicit new business. It is well recognized in these fields that such institutions cannot maintain themselves in healthy condition without new business efforts. Larger size not only benefits the management and selling organization, but also benefits the shareholders by making possible a reduced ratio

of operating expense and improvement and extension of research facilities.

New shares are sold from day to day at a price based on liquidating value, plus a selling commission which is added to the price, and which averages about 7½ percent. This commission is not out of line with the odd-lot brokerage commissions and taxes that the investor would otherwise have to pay to obtain a diversified list of securities. It also covers all costs of distribution, including various expenses of the distributor made necessary by the Securities Act and the qualification of the shares under the blue-sky laws of various States. It also provides compensation for the distributing organization that wholesales the shares, investment dealers throughout the country who offer them at retail, and salesmen of such dealers who sell them to individual investors.

The management and sales activities of open-end trusts are usually combined under the sponsorship of the same group of individuals.

Open-end trusts have been well conducted: In the management and operation of open-end investment trusts, honest mistakes of judgment have been made. Practical experience revealed certain weaknesses in their original setups which had to be improved. Further improvements are currently being made. In fact, the chief characteristic of investment trusts of this type is that the whole theory of their organization and operation looks first to the protection of shareholders against violation of their rights and the safeguarding of shareholders' interests as effectively as possible.

Among the more important of the protective features designed to safeguard the interests of shareholders are the following:

(*a*) They issue very complete and frequent reports to shareholders, usually every 3 months, containing independently audited financial statements including detailed income and expense statements, a list of securities owned and a schedule of all purchases and sales during the period under review. As a result, shareholders have the opportunity to judge for themselves how their interests are being served.

(*b*) The liquidating value of the shares is determined and published at least once every day, and thus a shareholder may know at any time the liquidating value of his interest in the company.

(*c*) With the exception of the leverage companies, which account for about 6 percent of the total assets of the industry, capitalization of an open-end company consists entirely of common stock with equal rights in all respects. There are no stock bonuses for management and no promoter interests. Accordingly, each shareholder's proportionate interest is determined solely on the basis of the number of shares owned.

(*d*) An open-end company does not seek to obtain control, or inject its influence into the affairs of a company in whose securities it invests except in the interests of their shareholders. Restrictions providing that no more than 5 percent of the assets of an open-end company can be invested in the securities of any one company, and that the trust may not acquire more than 10 percent of the outstanding stock of any one company, not only prevent the realization of any such aim, but they also reflect the spirit of their operation.

(*e*) Neither management companies, nor distributing companies, nor persons in any way affiliated with such companies, deal with

open-end companies as principals in the buying and selling of portfolio securities.

(*f*) The objective of most of these companies is not speculative profits but satisfactory long-term investment results with respect to both income and principal.

(*g*) Securities and cash comprising the assets of these companies are held in the custody of an independent agent, usually a bank or trust company.

(*h*) There are usually restrictions against borrowing, trading on margin, and short selling.

(*i*) The managements of these companies are compensated strictly on a fee basis, usually one-half of 1 percent annually of the average asset value, or sometimes a fixed percentage of investment income corresponding to the charges of trust companies for similar services.

These are important, practical safeguards developed over a period of years by responsible people in the industry whose aim has been to make open-end companies sounder and safer investment mediums. We have no objections, if it seems desirable, to requiring all open-end trusts to provide such safeguards as these.

The findings of 4 years of research and study by the S. E. C. investigating staff, as recorded in thousands of pages of testimony, statistics, and compilations, stand in support of the contention that these open-end companies, have as a group a record of clean and meritorious operation. This, it is believed, is deserving of thoughtful consideration before any legislation is enacted that might seriously endanger their continued successful operation, to the detriment of their hundreds of thousands of shareholders, whose average investment is not much over $1,000.

Objections to the proposed bill: This bill goes far beyond anything needed to cure abuses. Although professing to attain relatively simple and sound objectives, the bill is a highly complicated piece of legislation. It involves many controversial questions and subjects the investment-trust business to objectionable censorship, red tape, and bureaucratic control, much of which is mere duplication of procedure already required under the Securities Act of 1933 and other existing laws. The bill also places on distributors of investment-company shares burdensome restrictions that are not applied to the distribution of other types of securities, and to this extent represents unfair discrimination against the investment-trust business.

Moreover, the discretionary powers and delegations of legislative authority given to the S. E. C. under the terms of the bill are dangerously broad. An analysis of the bill reveals at least 51 separate and specific delegations of discretionary authority to the Commission, plus a blanket provision that gives the S. E. C. the right to issue rules, regulations, or orders of any kind that the Commission deems necessary or appropriate. If the bill is passed in its present form, Congress will be giving the S. E. C. carte blanche to regulate the investment-trust business in virtually any way it sees fit. It is difficult to see how anyone can successfully run a business subject to personal regulation dictated by a constantly changing Commission personnel.

The bill arbitrarily limits the size of investment companies at figures far below the existing size of many other types of financial institutions. This size limitation is imposed in spite of the fact that the S. E. C.'s long investigation did not indicate that size was any

handicap to successful operation. Quite the contrary, the record shows clearly that large size brings substantial benefits to shareholders in the form of lower operating costs. Nor is there any basis for the belief that size, in the case of open-end funds, involves any undesirable concentration of economic control; because trusts of this type, qualifying as mutual companies under the Revenue Act, cannot hold more than 10 percent of the stock of any corporation, no matter how large such trusts may be.

The bill also limits the amount of funds that may be managed by any one group. This is done by preventing the same group of individuals from being the controlling directors of more than one company. This latter provision will destroy, for no good reason, many long-standing business arrangements. In this country, as well as in Great Britain, several companies have frequently been built up and are today managed by the same group. For example, Robert Fleming & Co., whose late founder was the acknowledged dean of investment trust managers in Great Britain, has under its sponsorship a large number of investment trusts with assets running into high figures. Calvin Bullock, Inc., is interested in some five or six different companies. The trustees of Massachusetts Investors Trust also manage another company.

The bill also limits the right of an individual who has participated in organizing one company to participate in the organization of another company except with the approval of the S. E. C. We regard this as a restriction of the right of any businessman to organize legitimate business ventures as often as he wishes. The bill also denies investment companies in the future the right to issue senior capital, i. e., bonds or preferred stocks.

The provisions of the bill regulating the voting rights of security holders are so sweeping as to require a complete departure from the theory of continuity of management, upon which a number of long-established investment companies, which were organized as voluntary associations or trusts, have been built up and their securities acquired by investors. These provisions go much further than the best interests of their shareholders require.

Senator Taft. The question of stockholders, that you dealt with, presents this point about which I should like to inquire: Will you have to change all your rules to provide for voting, in the case of trusts?

Mr. Traylor. Some of these trusts have been in existence for 16 years. Mr. Griswold, who is chairman of the Massachusetts Investment Trust, the largest open-end trust of that type, will cover that point thoroughly, I think, Senator.

Senator Taft. I see.

Mr. Traylor. I think part of that will be dealt with this morning.

Senator Taft. You just mentioned your objection to the rule that there shall be only one type of securities. What is your objection to that?

Mr. Traylor. I think 90 percent of the open-end industry is made up of companies with only one class of securities. There are leverage companies in the open-end field.

Senator Taft. Do you see any particular advantage in that, so far as open-end companies are concerned?

Mr. Traylor. I certainly do not think it should be prohibited.

Senator TAFT. Why not?

Mr. TRAYLOR. If an investor wants to buy a senior security in a trust of that kind, I think he should have the right to do so. If he wants a more speculative security, more so than the ordinary trust share, I think he should be permitted to buy it.

Senator TAFT. Would you limit the percentage?

Mr. TRAYLOR. Yes; I think there should be something of that sort.

Senator TAFT. Do you mean not over a third of total assets, for instance?

Mr. TRAYLOR. Yes; something like that.

The restrictions provided in the bill as to who may serve as an investment trust director are so complicated as to defy analysis and seem, moreover, highly inconsistent. An investment banker or broker, for instance, may serve as a director of one trust but not of another trust that is not in the same system. If the S. E. C. feels that such an individual, because of possible conflicts of interest, would not make a satisfactory investment company director—a theory to which we do not subscribe—why is he allowed to serve at all? Why is he satisfactory in one case and not in another?

The bill also states that no director of an investment company can serve as a director of any corporation, less than 5 percent of the stock of which is held by the trust. If the trust, however, holds more than 5 percent, he is allowed to serve in that dual capacity. In other words, if the holding is large, so that the trust might be in a position to exercise undesirable influence or control, the arrangement is allowed; but when the holding is small, and no question of control or undue influence is involved, it is not permitted. This prohibits many of the country's best qualified men from serving on trust boards.

The general effect of all the provisions of the bill on the subject of directors will be to reduce substantially the number of qualified men who can or will accept directorships in investment companies.

Senator WAGNER. Mr. Traylor, may I ask you a question, at that point?

Mr. TRAYLOR. Yes, Senator.

Senator WAGNER. Do you think there ought to be any requirement that there be some independent directors, even though they may represent only a minority of the directors?

Mr. TRAYLOR. Well, in all my experience in this business I have seen no need for it.

Senator WAGNER. You heard Mr. Bellamy's testimony yesterday?

Mr. TRAYLOR. Yes, Senator, I did.

Senator WAGNER. He seemed to think that would be very healthy and very desirable. What is your opinion?

Mr. TRAYLOR. I think that is the opinion of a number of people in the business. I think it is also the opinion of many others that, with the years of experience they have had in the business, they see no need for it, whatever.

We believe that the industry genuinely wants legislation to prevent abuses and require uniform observance of high standards of operation. Such legislation would be most helpful to honest business, as it would reduce to a practical minimum the opportunity for malpractice or abuse and thereby weed out insofar as is practically possible the fringe element of unsound or dishonest individuals who, as in any business or profession, characteristically endeavor to exploit sound

ideas to their selfish and undeserved personal advantage. At the same time, it would help rather than jeopardize the preservation of the soundest principles and highest standards that the industry has developed in its 16 years of existence.

Other members of the open-end trust business, who will follow me, will give you more detailed criticisms of the specific provisions of the bill.

Senator WAGNER. Mr. Traylor, you said that legislation is desirable. Are you prepared to submit to the committee any suggestions of your own, instead of mere criticism of its present form?

Mr. TRAYLOR. I am in thorough accord with certain suggestions that I expect will be made by Mr. Griswold.

Senator WAGNER. I see.

Mr. TRAYLOR. And I think I am in thorough accord with the suggestions that will be submitted by Mr. Paul Cabot, who will follow me.

Senator WAGNER (chairman of the subcommittee). Very well; thank you very much.

Mr. TRAYLOR. Incidentally, Senator, would you like to have in the record this list giving the classification of investment trusts?

Senator WAGNER. Yes; thank you. It will be placed in the record.

(Document entitled "Investment Trust Classification, Gross Assets at Market, December 31, 1939, of Closed Management and Open-end Management Companies" is as follows:)

Investment-trust classification—Gross assets at market Dec. 31, 1939, of closed-management and open-end management companies

[Based on Moody's Bank and Insurance Manual for 1939, adjusted as noted where Moody's classification no longer is applicable, due to changes in charter provisions. Canadian companies, and a few other companies, believed to be small, where balance sheets at market were not available, have been omitted]

OPEN-END MANAGEMENT COMPANIES

A. Without senior capital:	*Total assets*
Administered Fund Second, Inc	$1,797,000
Aeronautical Securities, Inc	677,000
American Business Shares, Inc	6,613,000
American Foreign Investing Corporation [1]	794,000
American General Equities, Inc	167,000
American Securities Shares	184,000
Aviation Capital, Inc	517,000
Boston Fund, Inc	7,100,000
Broad Street Investing Corporation	7,445,000
Bullock Fund, Ltd	2,299,000
Canadian Investment Fund, Ltd	10,096,000
Central Investors Corporation	70,000
Century Shares Trust	12,949,000
Chain Store Investors Trust	119,000
Chemical Fund, Inc	7,390,000
Commodity Corporation	362,000
Commonwealth Investment Co	1,755,000
Delaware Fund, Inc	748,000
Diversified Investment Fund	389,000
Dividend Shares, Inc	46,423,000
Eaton & Howard Management Fund A-1	2,216,000
Eaton & Howard Management Fund B	713,000
Eaton & Howard Management Fund F	587,000
Equitable Investment Corporation of Massachusetts	224,000
Equity Fund, Inc	2,195,000
Fidelity Fund, Inc	4,001,000
Financial Security Fund, Inc	1,096,000
First Mutual Trust Fund	2,358,000

[1] Formerly Foreign Bond Associates, Inc.

Investment-trust classification—Gross assets at market Dec. 31, 1939, of closed-management and open-end management companies—Continued

OPEN-END MANAGEMENT COMPANIES—continued

	Total assets
A. Without senior capital—Continued.	
Fiscal Fund, Inc.:	
Bank stock series	$687,000
Insurance stock series	1,509,000
Fundamental Investors, Inc	8,903,000
General Capital Corporation	3,743,000
General Investors Trust	2,007,000
George Putnam Fund	2,436,000
Group Securities	6,617,000
Income Foundation Fund, Inc	1,607,000
Incorporated Investors	48,999,000
Institutional Securities, Ltd	2,955,000
Investment Co. of America	4,413,000
Investment Trust Fund B	1,669,000
Investors Fund C, Inc	5,750,000
Keystone Custodian Funds, Certificates of Participation (various series)	22,020,000
Loomis-Sayles Mutual Fund, Inc	2,333,000
Loomis-Sayles Second Fund, Inc	7,712,000
Manhattan Bond Fund [2]	3,929,000
Manhattan Bond Fund [2]	3,929,000
Maryland Fund, Inc	6,620,000
Massachusetts Investors Trust	123,111,000
Mutual Investment Fund	2,114,000
Nation-Wide Securities Co. (Maryland)	4,225,000
National Investors Corporation (Maryland)	14,937,000
New England Fund	3,479,000
New York Stocks, Inc. (various series)	10,864,000
Plymouth Fund, Inc	63,000
Premier Shares [3]	836,000
Public Investing Co	383,000
Scudder, Stevens & Clark Fund [4]	11,693,000
Selected American Shares, Inc	9,631,000
Shareholders Corporation	702,000
Sovereign Investors, Inc	470,000
Spencer Trask Fund, Inc	3,405,000
State Street Investment Corporation	39,382,000
Supervised Shares, Inc	8,595,000
Third Investment Counsel Corporation	999,000
Trusteed Industry Shares	5,203,000
Wellington Fund, Inc	5,219,000
Wisconsin Investment Co.[3]	1,569,000
World Investment Trust	118,000
Bay State Fund, Inc	
Bond Investment Trust	
Bond Investment Trust of America	
Burlingame Reserve Plan, Inc	
Collateral Equities Shares	
Fiduciary Fund, Inc	
Financial Shares Corporation	
First Management Foundation	[5] 5,000,000
Lexington Trust Fund Shares	
Market Street Investment Corporation	
Middle States Securities Corporation	
Mutual Income Foundation	
New York-Buffalo Trading	
Standard Utilities, Inc	
U. S. Electric Light & Power Shares, Inc. (Md.)	
Total open-end management companies (A) without senior capital	507,191,000

[2] Formerly Manhattan Fund, Inc.
[3] Reclassified.
[4] Formerly First Investment Counsel Corporation
[5] Estimated.

Investment-trust classification—Gross assets at market Dec. 31, 1939, of closed-management and open-end management companies—Continued

OPEN-END MANAGEMENT COMPANIES—continued

	Total assets
B. With senior capital:	
Affiliated Fund, Inc	$23, 397, 000
Quarterly Income Shares, Inc	21, 795, 000
Comsec Corporation	
Managed Estates, Inc	[5] 2, 000, 000
Republic Investors Fund, Inc	
Total open-end management companies (B) with senior capital	47, 192, 000
Total, open-end management companies	554, 383, 000

CLOSED-MANAGEMENT COMPANIES

A. Without senior capital:	
Bankers National Investing Corporation [6]	7, 263, 000
Boston Personal Property Trust [6]	4, 426, 000
Connecticut Investment Management Corporation	701, 000
Consolidated Investment Trust	14, 409, 000
First York Corporation	3, 880, 000
Goodall Securities Corporation	2, 623, 000
Gude Winmill Trading Corporation	242, 000
Inland Investors, Inc	2, 179, 000
Insuranshares Certificates, Inc	5, 157, 000
Investment Corporation of Philadelphia	1, 317, 000
Lehman Corporation	68, 618, 000
Liberty Share Corporation	615, 000
Morristown Securities Corporation	1, 175, 000
National Aviation Corporation	8, 801, 000
National Bond & Share Corporation	10, 797, 000
Oilstocks, Ltd	984, 000
Petroleum Corporation of America	22, 183, 000
Prudential Investing Corporation	1, 330, 000
Rochester Capital Corporation	1, 085, 000
Rockwood Associates, Inc	631, 000
Selected Securities Corporation	1, 760, 000
Shawmut Association	7, 108, 000
Tobacco & Allied Stocks, Inc	4, 996, 000
Union County Corporation	550, 000
Western New York Securities Corporation	740, 000
Brooklyn National Corporation	
Cambridge Investment Corporation	
Consolidated Assets Co	
Consolidated Equities, Inc	
Diversified Investment Trusts, Inc	
Gary First National Corporation	
Insuranshares Corporation of Delaware	[5] 6, 000, 000
Interbanc Investors, Inc	
Investors & Traders, Inc	
Managed Investments, Inc	
Retail Stores Corporation	
Sisto Financial Corporation	
Total, closed-management companies (A) without senior securities	179, 570, 000

[5] Estimated.
[6] Reclassified

Investment-trust classification—Gross assets at market Dec. 31, 1939, of closed-management and open-end management companies—Continued

CLOSED-MANAGEMENT COMPANIES—continued

B. With senior capital:	*Total assets*
Adams Express Co	$29, 126, 000
Air Investors, Inc	1, 274, 000
Aldred Investment Trust	4, 181, 000
Alliance Investment Corporation	1, 616, 000
American Capital Corporation	5, 208, 000
American European Securities Co	11, 155, 000
American General Corporation	23, 964, 000
American Insuranstocks Corporation	733, 000
American International Corporation	18, 733, 000
Amoskeag Co	12, 511, 000
Bankers Investment Trust of America	884, 000
Blue Ridge Corporation	36, 256, 000
Burco, Inc. (Sept. 30)	395, 000
Capital Administration Co., Ltd	5, 658, 000
Carriers & General Corporation	5, 890, 000
Central-Illinois Securities Corporation	3, 684, 000
Chartered Investors, Inc	5, 815, 000
Chicago Corporation	31, 978, 000
Commonwealth Securities, Inc	2, 296, 000
Eastern States Corporation (Md.)	3, 323, 000
Federal United Corporation	884, 000
Foresight Foundation, Inc	268, 000
General American Investors Co., Inc	30, 320, 000
General Shareholdings Corporation [7]	17, 427, 000
General Investment Corporation	2, 723, 000
General Public Service Corporation	4, 533, 000
Guardian Investors Corporation	1, 304, 000
Illuminating & Power Securities Corporation	8, 698, 000
Manhattan Financial Corporation	1, 691, 000
Niagara Share Corporation of Maryland	30, 059, 000
North American Investment Corporation	3, 538, 000
North American Utility Securities Corporation	5, 423, 000
Old Colony Investment Trust	4, 348, 000
Overseas Securities Co., Inc	2, 097, 000
Pacific Southern Investors, Inc	7, 269, 000
Penn Investment Co	364, 000
Pennsylvania Bankshares & Securities Corporation	2, 081, 000
Pennsylvania Industries, Inc	5, 217, 000
Petroleum & Trading Corporation	2, 027, 000
Prudential Investors, Inc. (Delaware)	9, 122, 000
Railway & Light Securities Co	9, 600, 000
Railway & Utility Investing Corporation	389, 000
Reynolds Investing Co., Inc	3, 034, 000
Second Investors Corporation	1, 049, 000
Security Investment Trust, Inc	468, 000
Selected Industries, Inc	33, 847, 000
Shawmut Bank Investment Trust	3, 190, 000
Tri-Continental Corporation	33, 052, 000
United States & Foreign Securities Corporation	36, 312, 000
United States & International Securities Corporation	29, 955, 000
Utility Equities Corporation	7, 761, 000
Utility & Industrial Corporation	2, 337, 000
Western Reserve Investing Corporation	1, 998, 000

[7] Formerly Electric Shareholdings Corporation.

Investment-trust classification—Gross assets at market Dec. 31, 1939, of closed-management and open-end management companies—Continued

CLOSED-MANAGEMENT COMPANIES—continued

B. With senior capital—Continued.	*Total assets*
Affiliated Trading Corporation	[5] $10,000,000
Allied International Investing Corporation	
American Investment Co. (Wisconsin)	
Argus Corporation	
Atlantic Securities Co. of Boston	
Betco Corporation	
British Type Investors, Inc	
Chain Store Investment Corporation	
Community State Corporation	
Empire American Securities Corporation	
Fairfield Securities Corporation	
Foundation Investment Co	
Guardian Bank Shares Investment Trust	
Guardian Investment Trust	
Guardian Public Utilities Investment Trust	
Guardian Rail Shares Investment Trust	
Investors Corporation	
Mutual Investors Co. (Wisconsin)	
National Investment Shares, Inc	
Oils & Industrials, Inc	
Pennsylvania Shares Co	
Petroleum Industries, Inc	
Scottish Type Investors, Inc	
Securities Corporation General	
Southeastern Investment Trust, Inc	
Tonawanda Share Corporation	
Utilities Associates, Inc	
Total closed-management companies (B) with senior capital	517, 065, 000
Total, closed-management companies	696, 635, 000

[5] Estimated.

Senator WAGNER (chairman of the subcommittee). The next speaker will be Mr. Paul Cabot, president of the State Street Investment Corporation, of Boston.

Will you please come forward, Mr. Cabot?

STATEMENT OF PAUL C. CABOT, PRESIDENT, STATE STREET INVESTMENT CORPORATION, BOSTON, MASS.

Mr. CABOT. Yes, Mr. Chairman; thank you.

I am Paul C. Cabot, president of the State Street Investment Corporation, of Boston, which was founded by me and my associates in July 1924. We are generally classified as an open-end company, or one of those that will always buy back shareholders' stock at a price approximately equal to the asset value. At the present time our assets amount to approximately $40,000,000.

Most open-end companies are continually selling additional shares to the public. However, in our case, our stock has been withdrawn from public offering since 1935, except in connection with the sale of stock made as a result of subscription rights offered to our shareholders.

Although we naturally stand ready to buy back shareholders' stock at any time and feel that this right of redemption is essential to their best protection, I am glad to be able to state that ever since 1936 we

have not been called upon to buy back any shares, because of the fact that our stock has continuously commanded a premium in the open market, substantially in excess of the asset value.

Mr. Bunker and other witnesses have already pointed out to you what must be self-evident, namely, that the S. E. C. witnesses in their testimony have paraded before you a group of the most shocking and sensational cases in this industry. It seems only fair, therefore, that I should be allowed under these circumstances briefly to mention the record of my company.

Upon organization in 1924, the shares of our company were worth $12.50. Today these same shares are worth approximately $72 a share, or a net appreciation of over 400 percent. In addition thereto, the annual return to the original shareholders in income and capital has aggregated $63.40 per share and has averaged in excess of 25 percent per annum.

I want to emphasize that the above figures apply to the original shareholders; but I am herewith submitting for the record a copy of our last annual report, which on page 5 shows how all shareholders have fared.

Would you like that, Senator, for the record?

Senator WAGNER. Yes. It will be placed in the record.

(Document entitled "Sixteenth Annual Report, State Street Investment Corporation, Boston, Massachusetts", is as follows:)

SIXTEENTH ANNUAL REPORT STATE STREET INVESTMENT CORPORATION, 140 FEDERAL ST., BOSTON, MASS., YEAR ENDED DECEMBER 31, 1939

Not to be considered an offer of sale or solicitation of an offer to buy unless a prospectus has been previously received and except in conjunction with prospectus

Directors.—Charles Francis Adams, Paul C. Cabot, David H. Howie, Richard C. Paine, Richard Saltonstall, R. Minturn Sedgwick, Henry L. Shattuck.

Officers.—Paul C. Cabot, *president;* Richard Saltonstall, *vice president;* Richard C. Paine, *Treasurer;* James G. Cronin, *Assistant Treasurer;* H. deF. Lockwood, Jr., *Clerk.*

Custodian and transfer agent.—The National Shawmut Bank of Boston.

Counsel.—Ropes, Gray, Boyden & Perkins.

Auditors.—Lybrand, Ross Bros. & Montgomery.

STATE STREET INVESTMENT CORPORATION,
Boston, Mass., January 30, 1940.

To Our Stockholders:

EXHIBITS

On pages 8 to 14 will be found statements of income and of surplus for the year ended December 31, 1939, a comparative balance sheet as of December 31, 1939, and December 31, 1938, and the list of securities owned as of December 31, 1939, all certified to by our auditors.

OPERATIONS IN 1939

At the beginning of the year 21 percent of the assets of your corporation was held in cash. During the first half of the year business activity declined somewhat and stock prices as measured by the Standard Statistics 90 stock average declined approximately 18 percent. During this period our common stock position was increased so that as of June 30, 1939, we showed a 15 percent cash position and as of September 30, 1939, a 9 percent cash position. During the third quarter business activity increased moderately and in the fourth quarter very sharply so that by December industrial production as measured by the Federal Reserve index was at its highest point in history. By far the greatest increase in business activity took place following the outbreak of hostilities in Europe. Stock prices, which reached a low point in April, were at their high point for the year by mid-September, and since that time common stocks as a group have

tended to move sidewise to slightly downward. A considerable amount of our stock purchases in 1939 took place during the market weakness of the first quarter of the year and just prior to the outbreak of the war. Following the rapid rise in stock prices after the outbreak of hostilities we sold some securities with the result that your corporation ended the year with approximately 13 percent of its assets in cash. Since the end of the year this cash position has been increased somewhat further.

Under date of December 22, 1939, we informed you that "Your corporation registered 49,718 shares of its stock with the Securities and Exchange Commission. This action was taken in order that the corporation would be able to offer to you additional stock in the event that circumstances toward the end of the year should make advisable the realization of substantial security profits and hence necessitate the payment of a larger special dividend." As this course was not deemed advisable, and as your corporation did not offer these shares, the management company assumed all the expenses in connection with this registration statement.

DIVIDENDS

During the year 1939 your corporation paid four regular dividends aggregating $2 per share and one special dividend of $1 per share, or total disbursements of $3 per share. Of this, approximately $2.85 represented dividends and interest received by the company, while approximately 15 cents represented gains from the sale of securities which are of a nonrecurrent nature. This compares with total dividends in 1938 of $6.75 per share, of which $1.75 represented dividends and interest received, and $5 was from nonrecurrent net gains from the sale of securities.

For the past several years your corporation has paid quarterly dividends in January, April, July, and October, and since 1936 has paid special dividends in December. Of recent years January dividends have been paid in anticipation of income inasmuch as substantially all of the income of a given year has been distributed in that year in order that the corporation might qualify as a "mutual investment company." Your directors have deemed it advisable to change the dates for the payments of the dividends of your corporation to April, July, October, and December. This action will result in four dividend payments in a year which will reduce the expense of dividend distribution and permit your corporation to pay dividends after the receipt of income rather than in anticipation thereof. Although this action caused the omission of the dividend that has heretofore been paid in January, it should not be construed as an indication of either an increase or a decrease in the total amount of the annual dividend distribution. We propose to continue as heretofore, and as required by the law pertaining to "mutual investment companies" to distribute substantially all of our income each year.

ORIGIN OF THE STATE STREET INVESTMENT CORPORATION

State Street Investment Corporation was formed under the laws of Massachusetts in June 1924. The original capital was entirely subscribed by the officers of the corporation and in the beginning the corporation was conducted as a private investment medium. The officers, directors and their families, as of December 15, 1939, owned approximately 19 percent of the outstanding shares, for which the corporation received full liquidating value at the date of purchase. No officer or director receives more than his pro rata share in the profits as a stockholder other than through his interest in the State Street Research & Management Co.

CAPITALIZATION

There is only one type of security outstanding—common stock without par value and with full voting power. There have never been nor are there outstanding now, any bonds, preferred stocks, or options, nor is it expected that any bonds, preferred stocks, or options will be created.

EXPENSES AND MANAGEMENT FEE

There exists a contract between your corporation and the State Street Research & Management Co., a partnership of which three of your officers, Messrs. Cabot, Paine, and Saltonstall are members, to provide management in consideration of a quarterly fee equal to one-eighth of 1 percent of the market value of the net assets plus $1 per share charged for shares repurchased by the corporation. This latter charge is borne by the retiring shareholders and not by the corporation. In consideration of this fee the partnership agrees to pay all expenses of manage-

ment, research, bookkeeping, etc. Aside from taxes and a few miscellaneous items, as detailed in the income account on page 8, the quarterly fee noted above represents the total operating expense.

SECURITIES AND EXCHANGE COMMISSION

During the past year the Securities and Exchange Commission issued a number of reports resulting from its investigation and study of the investment trust industry. As long ago as 1928 we called the attention of our shareholders to some of the abuses prevalent at that time in the investment trust field. In its studies it is natural that the Commission has emphasized those incidents of an unfavorable and dishonest nature that have taken place in the industry. As a result the reports tend to emphasize these unfortunate occurrences and have on the whole failed to call attention to the good aspects of those investment companies which have been honestly and capably managed. In spite of this criticism, however, we feel that these reports are thorough and accurate and we suggest that our shareholders who are interested procure copies from the Securities and Exchange Commission in Washington.

We understand the Securities and Exchange Commission will probably introduce a bill in the present Congress calling for the regulation of the investment trust industry.

FINANCIAL HISTORY OF THE CORPORATION

The following table shows changes in the size of the fund and in the per share net worth or liquidating value and gives the per share cash dividends paid each year.

Adjusted for stock dividend of 100 pecent, paid Jan. 15, 1929

	Net worth [1]	Number of shares outstanding	Number of shareholders	Net worth [1] per share	Annual per share dividends
July 31, 1924	$100,000	8,000	3	$12.50	
Dec. 31, 1924	165,796	8,000	3	20.77	
June 30, 1925	574,907	18,600	4	30.90	
Dec. 31, 1925	814,161	23,208	5	35.08	$3.50
June 30, 1926	1,110,095	33,420	6	33.22	
Dec. 31, 1926	1,351,607	37,024	22	36.50	2.50
June 30, 1927	2,072,174	51,104	51	40.55	
Dec. 31, 1927	3,334,024	62,308	95	53.49	2.00
June 30, 1928	5,868,880	87,428	188	67.13	
Dec. 31, 1928	12,105,970	126,372	280	95.79	2.50
June 30, 1929	21,129,614	174,389	612	121.16	
Dec. 31, 1929	17,249,549	197,833	800	87.19	3.00
June 30, 1930	17,502,311	194,762	775	89.87	
Dec. 31, 1930	11,732,276	182,103	759	64.42	[2] 3.00
June 30, 1931	11,438,534	179,726	725	63.64	
Dec. 31, 1931	7,847,087	177,050	704	44.32	3.00
June 30, 1932	5,909,605	173,489	873	34.06	
Dec. 31, 1932	7,392,061	172,977	862	42.73	2.50
June 30, 1933	14,080,344	212,458	1,053	66.27	
Dec. 31, 1933	21,030,143	323,851	2,365	64.94	1.70
June 30, 1934	24,146,632	373,075	2,959	64.72	
Dec. 31, 1934	27,466,241	421,647	3,408	65.14	1.60
June 30, 1935	32,684,592	477,150	4,008	68.50	
Dec. 31, 1935	42,283,151	476,915	4,154	88.66	1.60
June 30, 1936	49,208,083	471,749	4,185	104.31	
Dec. 31, 1936	50,193,968	472,711	4,309	106.18	22.25
June 30, 1937	50,043,984	499,990	4,783	100.09	
Dec. 31, 1937	34,275,781	499,990	5,138	68.55	4.50
June 30, 1938	36,273,458	499,990	5,436	72.55	
Dec. 31, 1938	38,341,347	520,971	5,673	73.60	6.75
June 30, 1939	35,004,461	546,905	6,081	64.00	
Dec. 31, 1939	39,271,450,	546,905	6,136	71.81	3.00

[1] Net worth is computed after all taxes, expenses, and dividends.
[2] On p. 10 of the prospectus dated Dec. 20, 1938, there was a typographical error. The dividend paid in 1930 appeared there as $5 whereas it should have been $3 as above.

MARKET FOR SHARES

The stock of State Street Investment Corporation has never been, nor is it expected to be listed on any stock exchange. Subject to the provisions of the vote of stockholders passed January 31, 1933, and subject to the possibility of revocation or amendment of that vote by the stockholders, the State Street Investment

Corporation will continue the purchase of stock offered to it at its liquidating value (as determined by the directors) subject to a charge of $1 per share, which $1 is paid to the State Street Research & Management Co. pursuant to its contract discussed previously.

FEDERAL TAXES

Your corporation continued to qualify as a "mutual investment company" as defined in the Internal Revenue Code. It is our opinion that all distributions paid to stockholders in 1939 are subject to Federal taxes.

ACKNOWLEDGMENT

Suggestions from shareholders are very welcome and we wish to thank those who in the past year have aided us in this respect.

Respectfully submitted.

PAUL C. CABOT, *President.*

TO STATE STREET INVESTMENT CORPORATION,
Boston, Mass.

We have examined the accompanying comparative balance sheet of State Street Investment Corporation as at December 31, 1939 and 1938 and the related income statement and statement of surplus for the year 1939, have examined or tested accounting records of the corporation and other supporting evidence and have obtained confirmation from the depositary, The National Shawmut Bank of Boston, of investment securities held for the account of the corporation as at December 31, 1939 and 1938.

In our opinion, the accompanying financial statements present fairly the position of State Street Investment Corporation at December 31, 1939 and 1938 and the results of its operations for the year 1939, in conformity with generally accepted accounting principles.

LYBRAND, ROSS BROS. & MONTGOMERY.

BOSTON, MASS., *January 25, 1940.*

Income statement

(Exclusive of realized and unrealized profit or loss on securities)

FOR THE YEAR ENDED DEC. 31, 1939

Income:	
Cash dividends received	$1, 763, 715. 45
Securities received as dividends (none on stocks of the same class)	92, 942. 75
Interest on bonds	4, 775. 00
Total	1, 861, 433. 20
Expenses:	
Fees for management services	187, 606. 50
Directors' fees	580. 00
Fees paid to transfer agent and depositary	28, 460. 09
Auditing, legal, and other operating expenses	7, 616. 84
Canadian and other taxes on dividends	7, 676. 76
Original issue taxes	3, 420. 98
Estimated Federal capital stock and Massachusetts excise taxes (note B)	84, 588. 50
Total	319, 949. 67
Net income for the year	1, 541, 483. 53
Dividends receivable after Dec. 31, 1939 (note A)	80, 632. 25
Total carried to accompanying statement of surplus	1, 622, 115. 78

NOTES:
A—Prior to Dec. 31, 1939, it was the corporation's practice to enter dividends in the accounts as of the dates they were due to be received. As at Dec. 31, 1939, the corporation adopted the practice of recording dividends in the accounts on the dates when the respective stocks first sell exdividend.
B—No provision is believed necessary for Federal income taxes.

Statement of surplus

(On the basis of pricing securities at market quotations)

FOR THE YEAR ENDED DEC. 31, 1939

Surplus at beginning of period	$10, 437, 325. 20
Add:	
Total from accompanying income statement	1, 622, 115. 78
Net gain from sales of securities	80, 667. 58
Refunds and adjustments of prior year taxes (net)	12, 150. 10
Total	12, 152, 258. 66
Deduct:	
Net decrease from change between the beginning and end of the period in unrealized appreciation of investment securities	1, 286, 873. 21
Cash dividends declared	1, 367, 262. 50
	2, 654, 135. 71
Surplus at end of period	9, 498, 122. 95

Comparative balance sheet

(On the basis of pricing securities at market quotations)

AS AT DEC. 31, 1939, AND 1938

	1939	1938
ASSETS		
Cash in banks	$4, 865, 687. 08	$8, 123, 838. 25
Accounts receivable from sales of investment securities	452, 682. 60	5, 872. 88
Accounts receivable from sales of the corporation's capital stock		495, 680. 56
Dividends and interest receivable (note A)	83, 334. 75	
Securities (note B)	[1] 33, 980, 300. 00	30, 183, 150. 00
	39, 382, 004. 43	38, 808, 541. 69
LIABILITIES AND CAPITAL		
Management fee	49, 151. 00	47, 986. 50
Accounts payable	12, 641. 52	116, 983. 23
Dividends declared		250, 000. 00
Reserves for taxes	48, 761. 50	52, 225. 00
Total liabilities	110, 554. 02	467, 194. 73
Common stock without par value (note C)	29, 773, 327. 46	27, 904, 021. 76
Surplus (note D)	9, 498, 122. 95	10, 437, 325. 20
Net worth	39, 271, 450. 41	38, 341, 346. 96
	39, 382, 004. 43	38, 808, 541. 69

NOTES:

A—The foregoing statement does not include, at Dec. 31, 1938, $55,522.50 of dividends receivable after Dec. 31, 1938 on stocks selling ex-dividend at that date. See income statement note A.

B—Securities at cost amounted at Dec. 31, 1939, to $33,577,799.87 and at Dec. 31, 1938, to $28,493,776.66.

C—Authorized 600,000 shares. Outstanding at Dec. 31, 1939, 546,905 shares and at Dec. 31, 1938 (including 6,801 shares subscribed) 520,971 shares.

	Dec. 31, 1939	Dec. 31, 1938
D—Capital surplus	$7, 115, 915. 73	$7, 115, 915. 73
Earned surplus	1, 979, 707. 09	1, 632, 036. 13
Total surplus, as per books	9, 095, 622. 82	8, 747, 951. 86
Unrealized appreciation of investment securities not reflected on books	402, 500. 13	1, 689, 373. 34
Surplus, as above	9, 498, 122. 95	10, 437, 325. 20

[1] See accompanying list of securities owned.

List of securities owned, Dec. 31, 1939

Number of shares	Securities	Quoted market prices [1]
	COMMON STOCKS	
6,100	Allis-Chalmers Manufacturing Co	$244,000
5,000	Aluminum, Ltd	480,000
3,000	Aluminum Co. of America	423,000
2,200	American Airlines, Inc	99,000
13,900	American Cyanamid Co. "B"	472,600
15,000	American Gas & Electric Co	570,000
26,000	American Metal Co., Ltd	624,000
3,000	Anaconda Copper Mining Co	90,000
6,400	Armstrong Cork Co	236,800
5,000	Atchison, Topeka & Santa Fe Ry. Co	120,000
9,500	Atlantic Refining Co	199,500
48,400	Borden Co	1,016,400
32,400	Burroughs Adding Machine Co	388,800
4,800	Caterpillar Tractor Co	259,200
18,000	Chrysler Corporation	1,602,000
11,800	Climax Molybdenum Co	460,200
37,500	Colgate-Palmolive-Peet Co	675,000
3,700	Colt's Patent Fire Arms Mfg. Co	303,400
15,000	Commercial Credit Co	705,000
4,000	Commercial Investment Trust Corporation	208,000
43,300	Continental Oil Co. (Del.)	995,900
9,700	Crane Co	223,100
24,000	Creole Petroleum Corporation	528,000
65,400	Deere & Co	1,504,200
31,900	Distillers Corporation-Seagrams, Ltd	606,100
22,000	Eastern Air Lines, Inc	660,000
6,900	Engineers Public Service Co	75,900
1,300	First National Stores, Inc	58,500
15,200	Flintkote Co	304,000
11,900	General Electric Co	476,000
10,500	General Motors Corporation	567,000
16,400	International Harvester Co	1,000,400
17,600	International Nickel Co. of Canada, Ltd	651,200
11,600	Kennecott Copper Corporation	429,200
8,500	S. S. Kresge Co	212,500
28,000	Kroger Grocery & Baking Co	812,000
7,700	Lone Star Cement Corporation	354,200
31,500	Marshall Field & Co	472,500
10,000	Glenn L. Martin Co	400,000
14,000	Montgomery Ward & Co., Inc	770,000
9,800	Mueller Brass Co	254,800
25,000	National Cash Register Co	375,000
50,000	National Dairy Products Corporation	850,000
17,600	National Distillers Products Corporation	422,400
2,900	National Steel Car Corporation, Ltd	147,900
25,000	North American Co	575,000
90,400	Niagara Hudson Power Corporation	542,400
3,000	Pennsylvania Railroad Co	69,000
43,500	Remington Rand, Inc	435,000
26,700	Safeway Stores, Inc	1,254,900
14,000	Schenley Distillers Corporation	168,000
9,900	Seaboard Oil Co. of Delaware	188,100
5,800	Sears, Roebuck & Co	493,000
40,900	Servel, Inc	613,500
117,600	Socony-Vacuum Oil Co., Inc	1,411,200
1,200	Sperry Corporation	54,000
33,000	Standard Oil Co. of California	825,000
22,800	Texas Corporation	1,003,200
6,600	Underwood Elliott Fisher Co	257,400
6,000	United Fruit Co	510,000
1,900	United States Gypsum Co	157,700
7,400	United States Smelting Refining & Mining Co	451,400
8,200	F. W. Woolworth Co	311,600
8,700	Youngstown Steel Door Co	234,900
	PREFERRED STOCKS	
10,000	Commonwealth & Southern Corporation $6	700,000
5,500	Electric Bond & Share Co. $5	324,500
5,900	Electric Bond & Share Co. $6	395,300
2,000	Radio Corporation of America $3.50 cumulative convertible	120,000
1,300	Worthington Pump & Machinery Corporation, 4½ percent, cumulative preferred	44,200

[1] The market value of securities is calculated at the price of the last quoted sale for the day, or in the case of no sale, the closing bid (such price or bid being adjusted to the nearest whole figure, fractions of one-half or less being marked down).

List of securities owned, Dec. 31, 1939—Continued

Number of shares	Securities	Quoted market prices
	BONDS	
Par value		
$117,000	Chicago, Milwaukee & St. Paul Ry. Co. series C 4½'s, 1989	$29,250
68,000	Chicago, Milwaukee & St. Paul Ry. Co. series E 4½'s, 1989	17,000
200,000	Erie R. R. Co., prior lien 4's, 1996	108,000
400,000	Erie R. R. Co., general lien 4's, 1996	96,000
100,000	Kansas City, Fort Scott & Memphis Ry. Co. 4's, 1936	30,000
405,000	Missouri Pacific R. R. Co. series F 5's, 1977	60,750
105,000	Missouri Pacific R. R. Co. series G 5's, 1978	14,700
143,000	Missouri Pacific R. R. Co. series H 5's, 1980	21,450
547,000	Missouri Pacific R. R. Co. series I 5's, 1981	82,050
45,000	Wabash R. R. Co. first mortgage 5's, 1939	17,100
100,000	Wabash R. R. Co. second mortgage 5's, 1939	19,000
200,000	Wabash Ry. Co. series B, 5's, 1976	18,000
	Total	33,980,300

Mr. CABOT. In his opening remarks to you, Judge Healy quoted from an article that I wrote in March 1929, for the Atlantic Montly, wherein I described at some length the many abuses and malpractices by a few members of the industry at that time. He did not, however, quote from that same article what I suggested should be done about these abuses. I think it only fair, therefore, that I should quote from the same article the following:

What can be done about these abuses? I should say that the remedies are publicity and education. Every industry has its abuses and dangers, and many industries present far more alarming hazards than the investment trust. Before touching on these rememdies I should like very briefly to say a word about what purports to be remedial legislation. There has been much discussion of this topic, and many States have already gone far in setting laws on their statute books. Just as in the case of charter restrictions, about all these laws can do is to hamper able management and fail to protect the public against inability and dishonesty. No law can replace the necessity for investors to think intelligently and to investigate a situation before investing their money. We have had many examples of the evils of overregulation in other fields, and it would indeed be unfortunate to hamper by laws that cannot accomplish their purpose so valuable an instrument of finance as the investment trust.

Remember that the above was written in 1929—11 years ago.

I hand you a copy of that article in full.

(Pamphlet entitled "The Investment Trust," by Paul C. Cabot, is as follows:)

THE INVESTMENT TRUST

(By Paul C. Cabot)

I

Although there have been investment trusts in operation in this country for over 40 years, they have not until recently enjoyed any prominence, nor have large amounts of capital been invested in them. The idea was really first developed in Great Britain and had already attained considerable proportions as early as 1880. The investment-trust plan as conceived by Mr. Robert Fleming, who is now possibly the most important English investment-trust manager, is more or less typical of the entire movement at that time. Coming from Dundee to New York as a mercantile clerk, Mr. Fleming was greatly impressed with the possibility of investing funds in this country, particularly in our then rapidly growing railroads. It was possible for him at that time to borrow money in England for as low as 3 percent and then turn around and lend it to the American railroad companies, taking their first-mortgage bonds for as high as 6, 7, and indeed 8 percent. Obviously the profits for the promoters and common-share

holders were very large, and the movement expanded rapidly. By 1888, 18 of these trusts with a capital of over £23,000,000 were listed on the London Stock Exchange. By 1890 a trust "mania" was under way. For some years the British debt had been steadily reduced; capital had continued cheap and abundant; the investment trusts had been uniformly successful, paying large dividends, and there had been rapidly mounting quotations for their securities.

Referring to this "boom" in the investment-trust plan, the London Economist for April 6, 1889, remarks that "although successful with the public, the companies have not in some cases been able to make a very favorable start in business, for they have followed so fast upon each other's heels that they have experienced great difficulty in purchasing proper investments. The supply of really sound securities is in many directions so very limited that any decided increase in the demand at once causes a considerable advance in prices * * * indeed so rapid has been the advance that it is stated several of the new trusts have been unable to effect purchases and are rather doubtful as to the direction in which their money shall be invested."

These words have certain interesting applications to the present situation. As a result of the conditions described by the Economist a variety of abuses arose. The pryamiding process, or superimposing of one company on top of another, increased rapidly. For example, the Anglo-American Debenture Co. was responsible for the creation of 13 different but interconnected trusts at this time. This in itself might not have been objectionable had it not resulted in the manipulation of accounts, the creation of corners, and a great deal of general maneuvering in order to sustain and increase the market value of the securities of the various trusts. In my opinion there is today in this country a large and well-known investment trust whose shares are selling for far more than their intrinsic or liquidating value, which has continually managed its portfolio so that it can show the greatest possible profits and thereby obtain the greatest market value for its shares, regardless of their real worth. Generally speaking, in this trust during the past year the good securities that have appreciated in value have been sold and the poorer ones retained or increased, simply to show profits.

The Economist tells us that this is exactly the game they were playing in England almost 40 years ago. In 1890 the Baring crisis marked the beginning of a long period of difficulty for the investment trusts. It is interesting to note some of the expedients resorted to by the managers of the tottering trusts at this time. Mr. J. Edward Meeker, economist of the New York Stock Exchange, in an interesting paper on the subject, cites the following instance. "The 'Imperial and Foreign Investment and Agency Corporation,' with a 'strong board' of directors, saw fit to carry the valuations of their holdings at cost instead of at market prices, and on this basis to declare a dividend which absorbed £20,000 of their fictitious revenue balance of £32,409. The long-suffering auditor revolted and refused to shoulder further responsibility for the company's accounts." By April 1891 the ordinary and deferred shares of 10 of the more important trusts had declined in the market on an average of 34 percent. In February 1893 the Economist made the following commentary: "It may be said with truth that, having sown the wind, they (the trusts) are now reaping the whirlwind. Week after week evidence accumulates proving only too forcibly that those responsible for the management of these trusts have based no inconsiderable part of their operations upon false principles, with the inevitable result that, after a more or less brief period of apparent prosperity, losses and difficulties have arisen." Scandal followed close on the heels of financial difficulty. It turned out that the banking house of Mruietta & Co. "had agreed to subscribe for 12,000 shares of the "Imperial and Foreign Investment and Agency Corporation" provided the latter would purchase from it certain securities which it had been unable to sell elsewhere. These depreciated £114,358 while in the trust's possession. What stirred the ire of the shareholders was that despite their losses the trust, directors, and managers had made fortunes." [1]

It was not until 1896 that the Economist noted "the upward movement in prices of trust securities generally."

I have given at some length the history of the difficulties of the investment trusts in England because I strongly believe that unless we avoid these and other errors and false principles we shall inevitably go through a similar period of disaster and disgrace. If such a period should come, the well-run trusts will suffer with the bad as they did in England 40 years ago. Of course, the honest and ably managed companies would emergy from the difficulties eventually. Even during the worst period in England "proof was afforded of the innate soundness of the

[1] Some Notes on Investment Trusts, by J. Edward Meeker.

investment-trust idea when properly administered." Of the 31 leading trusts of the time studied by the Economist, 7 were able to make headway against the completely adverse current of conditions. In the hope and belief that we shall profit by the example of the older trusts and escape the worst of their difficulties, I shall now try to point out what in my opinion are some of the present dangers. Before doing so, however, I should like to emphasize the fact that the honesty and ability of the management are paramount and that good practices can be completely vitiated by dishonest and unsound investments.

II

Of the investment trusts of which I am speaking I propose to recognize two broad classes. First, those whose primary idea is the borrowing of money at a rate lower than that at which they can lend or invest it, and which in their investment program follow a very wide diversification. Second, those that do not follow such wide diversification and that buy with the idea of appreciation, or that have attempted to buy securities which are cheap and will go up over a period of years. In England these two classes are generally differentiated as "trust companies" and "finance companies." In this country we have tended to group them all under the general category of investment trusts. Both types have advantages and disadvantages that appeal variously to different investors. The broadly diversified trust has relatively small holdings in a great many issues. It attempts to secure a cross section of the various securities of the United States or of the world. Its particular advantages are that it permits small investors to participate in the ownership of a widely diversified group of securities, thereby obtaining such benefits as go with wide diversification. By its very nature, however, it is attempting to secure a representative average; it cannot, therefore, hope to turn in more than an average performance. Now the primary object of buying into an investment trust should be the desire to have expert and constant management which can do better than the average. As we have seen, however, a very broadly diversified portfolio means average results, and therefore the purchaser of the securities of such a trust cannot expect the full benefits of managerial ability. Of course, in fairness it should be said that poor management cannot do as much harm following wide diversification as otherwise.

There is a restriction in the by-laws of one investment trust which provides that as soon as the trust has $5,000,000 it shall have at least 400 different issues. In contrast to this, the trust indenture of the Investment Managers Co. of New York provides that it shall not have more than 30 issues. The first company has by its policy of diversification attempted to obtain security. The Investment Managers Co. by its opposite policy has, however, obtained greater security. No one can get an issue into the portfolio of the Investment Managers Co. without proving to the directors that it is not only good, but better than one of the existing issues for which it is to be substituted.

In the other company almost any security will get by. The pet issue of each director and officer can find its way in. Director A passes director B's security, although he may not be very enthusiastic about it, so that director B will not blackball his issue. Another disadvantage to the highly diversified portfolio is either the inability of the management to follow closely so many issues or the expense of so doing. One of the worst of some of the present abuses is the ignorance and lack of attention of some investment managers. An investment-trust manager should know far more about the companies in which his money is invested than the average investor. This, I am afraid, is not always the case, and obviously it is far more expensive to follow closely and thoroughly a list of securities spread all over the face of the globe than a list restricted to a limited group of the best investments. I think it fair to say that the average highly diversified trust does not closely follow its list, but relies on its policy of diversification to save it, and, therefore, cannot produce more than an average showing.

In pointing out the difference between these two types of trust, I have already touched on one of the cardinal abuses—inattention. Of course, this evil may apply to the trust with a more limited and selected portfolio. I should also like to point out that it may apply to those trusts run by the big banks and brokerage houses. They may be honest and they may be able, but before their securities are bought one wants to be sure that they will continually apply and reapply that ability to the running of the trust into which one may be buying.

I think the worst cases of lack of attention come where the managerial control rests in rather numerous hands. Concentration of control with extensive powers is a feature of the utmost importance, avoiding the delay and lack of positive action that usually result when many individuals holding diverse opinions attempt to translate their ideas into action.

Some months ago I was asked by an investment house if I would consider running an investment trust that they had sold to the public some time before. During the course of the discussion I asked if I might see the portfolio. In examinining this, I noted a very large block of the shares of a company which, as a banking house, they had recently acquired and sold to the public. I asked the gentleman with whom I was talking whether, if I were to advise them on their portfolio, and if I could convince the directors that the shares of another company in the same industry were a preferable investment, they would make the exchange. He replied, "No, not necessarily. This trust is part of our general machine, and if the selling of these shares adversely affected—— & Co. we would not make the sale." And yet the securities of this trust were sold to the public, whose money was being used not for the best interests of the men and women who had supplied the funds, but for the best interests of —— & Co. This case brings up two common abuses to which the investment trust is now being put. First, that of being run for ulterior motives and not primarily for the best interests of the shareholders; second, that of being used as a depositary for securities that might otherwise be unmarketable. There are, of course, certain trusts that have been formed with avowedly ulterior purposes. Such procedure is obviously beyond reproach. It is only when a trust says it is formed to accomplish one thing and then attempts to do another that it becomes an abuse.

The practice by which a house of issue sells a part of its own underwriting to its own trust, although not necessarily unethical and unsound, is extremely dangerous. Those trusts run by banks and brokers are particularly subject to this temptation. In my opinion such companies should have a provision or a firmly established policy that they will in no way deal with themselves as principals; that if they wish to acquire part of an issue in which they as a house may be interested they will have to acquire it from some entirely outside source.

III

Some months ago, in testifying before a committee of the New York Stock Exchange, I was asked to state briefly what were, in my opinion, the present abuses in the investment-trust movement. My reply was: (1) dishonesty; (2) inattention and inability; (3) greed.

It is of the last of these that I now wish to speak. You may be asked to subscribe to a trust that is both honestly and ably run, and yet find it inadvisable to to do simply because there is nothing in it for you. All the profits go to the promoters and managers.

There are an infinite number of ways whereby this unduly large slice of the spoils is kept by the insiders. They may own all or a very large percentage of the equity stock; they may have warrants and options; or, more rarely, they may be able to take out the money in the form of expenses or managerial fees of one sort or another. There certainly is no ethical objection to promoters and managers getting away with all they can in the way of profits. Free competition is bound to keep this down to a reasonable figure. The objection comes when the amount so to be taken out is not clearly set forth. The most common method of accomplishing this result on the part of promoters is an exceedingly complicated capital structure. There are many investment-trust prospectuses in which it takes literally hours to figure out just how profits are to be divided. To those not trained in finance the task becomes impossible, and the promoters have accomplished their purpose. Certainly a clear statement of how the money is supplied and the profits divided, together with a simple, straightforward capital structure, is highly desirable.

Another danger, usually the result of greed, takes the form of a very large funded or floating debt or an excessive issue of preferred stocks. Very often the managers and promoters receive their compensation and profit in the form of common stock for which they have paid little or nothing. There is nothing to criticize in this procedure if it is clearly and simply stated so that all can easily understand. As is pointed out in such cases, the management receives nothing until it has earned and paid some fixed percentage on the senior securities. In other words, the compensation is dependent upon the success of the enterprise. But the difficulty is that the management or promoters have put up only a very small percentage of the total funds. If the enterprise is a complete failure, they have little or nothing to lose. It is natural, therefore, that they should take the attitude of "Let's either win big or win nothing." This they accomplish by a very heavy pyramiding process. I do not believe that there are many people who with only $100 equity would, as a general practice, proceed to borrow and buy anywhere from $800 to $1,000 worth of securities, and yet this is exactly what many investment trusts are doing today.

There is another difficulty to which pyramiding leads. With very heavy fixed charges and preferred dividends to meet, the management is under the constant necessity of producing a large dollar income the first and every succeeding year of operation with which to meet the relatively large fixed charges. This pressing necessity to produce immediate and constant income forces the investment of a large proportion of the funds in securities of a less desirable type.

A danger that I have already spoken of I should like to touch on again. There are a great many trust indentures, bylaws, and more or less formal policies that provide a variety of restrictions, the basic purpose of which seems to be to prevent, in the case of dishonest or incapable management, a complete dissipation of the funds.

Suck a motive is praiseworthy, but all the restrictions in the world will not mitigate the evils of poor management, and about all they can do is to restrict the efforts of good management. Is it not probable that excess restrictions which we may place on the investment-trust manager during a period of rising prices may be entirely wrong for a changed period of declining prices? I believe that no principles and restrictions should be developed so rigidly that they may not be changed at any time in order to conform with the best judgment of the management.

There are a great many other dangers confronting the investment trusts, but there is only one other I wish to mention here, and that is the excessive market price to which, in my opinion, the shares of certain trusts have been bid. To say what is a fair price for such securities I find extremely difficult—indeed, I do not know. I do think, however, that there are a few principles which may aid us in this determination.

Where the assets of an investment trust are not grossly overvalued, I should say that its various securities are at least worth the net liquidating value, or what would be realized in actual liquidation. The difficulty comes in saying how much more than the liquidating value the securities may be worth. I can think of only two factors that might bring this out. The first is the factor of management, and the second is the ability of the trust to borrow money at low rates of interest. If, for example, the X Trust can borrow $5,000,000 at 5 percent for 20 years, that ability undoubtedly has a present market worth. Similarly, the ability of the management to make money in excess of the current rate of return over a period of years also has a present value. When, however, I find the shares of a very large trust selling in the market for nearly three times their liquidating value, particularly when that liquidating value is figured from a grossly inflated portfolio value; when there is not possible value to be added through funds borrowed at a low rate; and when, on top of it all, the management has in my opinion demonstrated inability and possibly dishonesty, I am inclined to think the shares somewhat high.

IV

What can be done about these abuses? I should say that the remedies are publicity and education. Every industry has its abuses and dangers, and many industries present far more alarming hazards than the investment trust. Before touching on these remedies I should like very briefly to say a word about what purports to be remedial legislation. There has been much discussion of this topic, and many States have already gone far in setting laws on their statute books. Just as in the case of charter restrictions, about all these laws can do is to hamper able management and fail to protect the public against inability and dishonesty. No law can replace the necessity for investors to think intelligently and to investigate a situation before investing their money. We have had many examples of the evils of overregulation in other fields, and it would indeed be unfortunate to hamper by laws that cannot accomplish their purpose so valuable an instrument of finance as the investment trust. All that legislation should do is to require a degree of publicity that will enable any investor to form a sound opinion. It should not require publicity that would interfere with the honest and successful operation of the trusts.

For the publicity that not only should be required, but is good policy for the trust, I should suggest the following provisions. First, a clear statement should be made showing exactly where the control lies and who constitutes the active management. Second, it should be shown exactly how and in what proportion profits and losses are divided, particularly the existence of options, warrants, calls, and the like. Third, the investment policy of the managers should be made plain by figures giving the percentages invested in the various classes and types of securities.

There has been much discussion of the advisability of requiring that complete portfolio holdings be revealed. Arguments in favor of revealing them include the following points:

1. The trust cannot be called and ceases to be a blind pool.
2. Dishonest or mistaken investment policies are more quickly revealed.
3. Public confidence is increased; the trust is ashamed of nothing and has nothing to hide.
4. The security holders of the trust can better appraise the trust investment policies and attune the rest of their investment procedure accordingly.

Among the disadvantages of portfolio publication are these:

1. The results of the costly investment research paid for by the security holders of the trust are revealed to all, and an outsider by following the list can get the same benefits free of charge.
2. Where a trust is either selling or buying a security with a limited market, that market can be seriously interfered with to the deteriment of the trust.
3. Investors may be misled. An investment that is good for a trust may not be good for an individual, particularly when the individual does not know and cannot follow the risks and hazards involved.
4. Publication of a list can seriously hamper the managers in their investment research.

Generally speaking, I should say that for trusts pursuing a very wide diversification the publication of their lists is advisable; whereas for that type which tends more to concentration and the selection of a few outstanding issues it is inadvisable. The best English practices have tended away from the publication of holdings.

Every trust should publish complete balance sheets and income accounts. The balance sheets, of course, should reveal all liabilities, contingent or otherwise; securities should be carried at cost, but their present market value should be clearly revealed. Such a policy permits anyone to determine exactly the liquidating value which is essential in a determination of the value of the various securities. The income account should be detailed and reveal exactly from where the income was derived. It is essential that interest and dividends received should be clearly separated from profits from sales. Similarly, the expense account should be broken down, showing how much is paid in salaries and other overhead expenses. The compensation of management should be segregated.

If the investment trusts of the country pursue this policy of complete information, bad practices, simply by revelation, will be eliminated.

V

In pointing out some of the present abuses of the investment-trust movement, I have indicated by inference rather than directly what can be considered sound and constructive practice. It only remains briefly to suggest what can and has been accomplished in this field when these dangers and abuses are avoided. Without enlarging on the various possible benefits accruing to investors in this movement, I should merely like again to say that far and away the most important contribution that the investment trust can make is to supply honest, constant, expert, and unbiased management, and that if it pursues too extensive diversification it indicates that it will not or cannot supply that management. For investors to pay a heavy loading charge, in the form of management charges and sales commissions, to the managers and promoters of a "fixed trust," who by its very charter are restricted from using any judgment whatsoever, is in my opinion ridiculous and unjustifiable.

I am often asked what will happen to the investment trusts during a period of declining security prices. In my opinion it is during that period that the real value of the investment-trust movement can be demonstrated. The investment-trust manager should be a financial expert similar in his profession to the doctor of medicine. When we most need a medical doctor is when we are sick. Equally it should be, and I believe is, true that when the investing public most needs expert assistance is during a period of falling security prices. Almost anyone can make money during a period of rising prices, but it will take real skill to curtail losses when things are moving in the opposite direction. I should not go so far as to say that the well-run trusts will not lose money during a period of deflation; but certainly they should, and I believe will, lose less money than the average investor. With conservative capitalization, sound policies, and able management, the investment trusts will make more money than the average investor in good times and lose less in poor times. Such a performance not only justifies but ensures their existence and growth.

Mr. Cabot. I thought at that time and I still think that this industry needs a regulatory law, and I believe that the vast majority of the members of the industry concur in this belief; but I do not think that the present bill is the soundest approach to the problem.

We are in a fortunate position with respect to the specific provisions of the bill which is before you, in that except in one instance we are not affected by it, insofar as I can judge. I do not mean to imply by this, of course, that we will not be affected by any or all of the innumerable rules, regulations, and orders that the bill in its present form authorizes the S. E. C. to issue. Nevertheless, I have felt that I ought to call to your attention some of the general objections I have to this bill, regardless of the fact that they might not affect my company.

They are, first, that under the provisions of section 10, subsection (e), it is proposed to make it illegal for anyone to serve as an officer or director of an investment company who, perchance, might be an officer or a director of one of the companies whose securities are held in the portfolio. Under section 30, subsection (e), any officer or director is required to make a complete report each quarter as to any purchases or sales he personally may have made in portfolio items in which transactions have occurred. I object to these provisions. Both will tend to make it extremely difficult to secure and retain the services of directors who are by training and situation competent to aid, advise, and administer the affairs of investment companies. I can see no sense in a law which states that because we happen to have 1 percent of our assets in shares of the General Electric Co., Mr. Blank, a director of that company, cannot serve as a director of our company.

Senator Taft. Does the proposed law require that if that gentleman buys and sells shares of General Electric, for instance, he shall report that?

Mr. Cabot. Yes, sir—if the trust has any transaction in that same stock, either buying or selling in that same period.

Senator Taft. Very well.

Mr. Cabot. Is that correct?

Mr. Schenker. As I understand it, Mr. Cabot, what the bill provides is that an officer or director who effects any transactions in the security in which the investment trust has effected transactions, still has to report those transactions to his own board of directors; whereas, if he effects transactions in securities in which the investment trust is not making transactions, then he does not have to report them.

Mr. Cabot. That is my understanding, too; but also there is a provision in another part of the bill that the S. E. C. can demand any document from any of these people and then can make public any of these documents. So, assumedly, they have it in mind.

Mr. Schenker. You seem to have it in mind.

In other words, if we had it in mind, I think you can proceed on the assumption, Mr. Cabot, that we would recommend to the committee that they would not only make it available to the board of directors but also to the general public.

Mr. Cabot. Well, possibly you gentlemen do not have it in mind today, but your successors might get it in mind. [Laughter.]

Many directors will seriously object to the "snooping" provided for in the second provision and, in order to avoid subjecting themselves to this procedure, will prefer not to serve as directors of an investment

trust. The result will be that investment trusts will be forced to elect outside directors—and the bill requires that these shall be in the majority—from among those individuals who have no business affiliations, connections, or property of their own; and the boards will be filled with artists, architects, musicians, doctors, and the like.

Senator TAFT. And perhaps some lawyers? [Laughter.]

Mr. CABOT. I did not mention lawyers.

I think that the shareholders will be hurt rather than helped by such a provision.

Senator WAGNER. I should like to get your view, as well as that of the other witnesses, with respect to whether there should be some independent directors.

Mr. CABOT. Are you asking me about that, Senator?

Senator WAGNER. Yes.

Mr. CABOT. I am inclined to think that there should be; and I shall take up that matter later, with your permission, Senator.

Senator WAGNER. Oh, you are going to take that up later?

Mr. CABOT. Yes.

Senator WAGNER. All right; then I shall not ask you to discuss that at this particular point.

Mr. CABOT. Our second objection is that we believe this bill, under sections 18 and 19—if it becomes a law—forces the breaking of many legitimate contracts that have been entered into in good faith by the contracting parties. Let us take an example: An investment trust was formed some year ago with a capital of $10,000,000, $5,000,000 contributed by preferred stock and $5,000,000 contributed by common stock. Let us assume that at that time the preferred-stock holders had been given prior rights to dividends and, in the event that dividends are not earned or paid, the right to vote in the affairs of the corporation; but so long as their dividends are paid and earned and so long as there is complete asset value behind each of their shares of stock, they have been specifically exempted from voting. Now let us assume that because of existing conditions the market value of the $10,000,000 fund has shrunk to $7,500,000: It is obvious that the preferred stock is still fully covered by assets, and let us assume that its dividends have been continuously earned and paid. Let us further assume—and this condition is typical of the present situation—that this preferred stock, which was originally issued and sold at $100 a share, is now selling on the market for only $80 a share. Under the provisions of this bill, if it is passed, the preferred-stock holders could first go to the Commission and obtain the right to vote in the affairs of the corporation, thereby breaking the original contracts entered into in good faith. This might give them two-thirds of the voting control, as against one-third in the common stock.

With this two-thirds vote, they could call a meeting and by their vote could force the liquidation of the company. Their primary motive for doing this would be to get the market value of their preferred stock up from $80 to $100, or what they would get in liquidation. However, such action would be grossly unfair to the common-stock holders, who would be frozen out by such procedure and would be unable to recoup the loss which would be forced upon them by such action, and this despite the fact that they had lived up to the letter and the spirit of the contract with the preferred-stock holders. We cannot believe that it is sound to put into the hands of the Commission

absolute power to break any previously existing contract that was entered into in good faith.

Third, section 5, subsection (b) (1) (c) prohibits a diversified investment company from having a portfolio turn-over in excess of 150 percent. The Commission seems to think that a relatively rapid turn-over of portfolio securities is either in some way wicked or, at best, highly speculative. I believe that portfolio activity per se is neither necessarily wicked nor speculative and that, at times, it is essential for the protection of security-holders.

For example, if an investment company, whose total assets aggregated $10,000,000, started the year 1933 with 6 millions of those assets invested in cash and Government securities and 4 millions in the most stable common stocks, and if it decided that due to the sudden change for the better in the basic economic situation it was advisable to swap the 4 millions of stable common stocks into 4 millions of stocks that would benefit more greatly through a business recovery, then under the definitions of this bill such a transaction would exceed the portfolio turn-over limitation. We submit that this is ridiculous and if this restriction is permitted to stand, it would very seriously jeopardize the best interests of security holders.

Senator TAFT. What is that 150 percent? Would not that mean that you could change them all over once and then 50 percent more?

Mr. CABOT. As I understand the bill, or as the bill reads, it says 150 percent of the value of securities, exclusive of cash and Government bonds; so that in the example that I have given you, 40 percent of the securities would constitute the only securities that would be measured under this rule; so that the transaction I have described would represent a turn-over of 200 percent, as at present defined.

Senator TAFT. Why 200 percent?

Mr. CABOT. Well, buying once and selling once.

Senator TAFT. Oh, each one counts?

Mr. CABOT. Each one counts.

Senator TAFT. That is in the definition section somewhere?

Mr. CABOT. Yes, sir. I think I can find that for you.

Senator TAFT. That is all right; I can find it.

Mr. CABOT. Page 93, line 23, it begins.

Senator DOWNEY. May I intervene at this point, to ask the witness a question?

Is there any provision made that the turn-over can be greater, by application to the S. E. C.?

Mr. CABOT. I think there is such authority, but I am not sure.

Mr. SCHENKER. On that aspect, Senator, the bill puts no limitation on the portfolio turn-over, if you do not want the title of a diversified investment company; so that if you want to turn over your portfolio seven or eight times a year, this bill does not prevent it; the only thing it says is that you shall not call yourself a diversified investment company.

Now, with respect to a diversified investment company, in our original presentation we were not unmindful of the difficulties of these situations; because we specifically indicated them as part of our affirmative presentation: and we manifested at no point difficulty with that situation.

What we intended to do, Senator, was to draw a distinction between the type of company like Mr. Cabot's which is not—as he says—

touched by this bill except as to possible future rules that the Commission may propound under the specific provisions, and the type of company like Mr. Bellamy's company, that had a portfolio turn-over of 7.44 last year.

We say that an individual who wants to go into Mr. Cabot's type of company should know that that is the type of company.

Now, Senator, you can visualize, can you not, that he may start out like Mr. Cabot's company and then suddenly become a company of the type of Mr. Bellamy's company, where he is no longer in a company that takes long-term investments, but is in a trading company?

Senator TAFT. Let me ask this, please: What is the effect, then, of what he represents his securities to be when he sells them? Is there any difference between the treatment of a diversified investment company and a securities trading company?

Mr. CABOT. May I answer that, Senator?

Senator TAFT. Well, first let us see what Mr. Schenker has to say about that, please.

Mr. SCHENKER. There is no difference in treatment, except you remember Judge Healy indicated that, as far as he was personally concerned, if a person was operating as a trading corporation, possibly he should be permitted to short-sell, and we have no restrictions on short-selling whatever, except a size limitation.

Senator TAFT. A size limitation?

Mr. SCHENKER. Yes.

Senator TAFT. There is another section which gives the Commission practical power to classify companies in any way they choose, is there?

Mr. SCHENKER. No; subject to certain specific provisions in the bill, Senator.

May I just make this observation, please: The fact of the matter is that these mutual open-end companies which get the tax preference, recognize the distinction between a company which turns over its portfolio very rapidly, which is nothing but a speculative investment trust, and the type of trust conducted by Mr. Paul Cabot, which is an investment trust; because section 48 (e), which gives the tax preference, specifically says that you lose your tax preference if more than 30 percent of your income comes from the sale of securities which you have held for less than 6 months.

That was the formula they devised to make sure that a trading corporation does not get the tax preference; because the fundamental approach of section 48 (e) is that if you have a mutual company and it has a limitation on the amount of borrowings and debt outstanding —and it really applies to one-class stock trusts—a one-class stock trust which does not have a rapid portfolio turn-over but which has these diversification limitations was treated specially with respect to taxation.

Now, Senator, as I understood it in my numerous talks with the members of the industry, they had difficulty with the Treasury's formula; because in order to get within that 30-percent provision, what would they do? They would have deliberately to sell securities in which they could take a loss, to offset the amounts they made on other securities; and it just was not good investment judgment.

What they were doing was that they were compelled to sell securities, to take a loss, even though their investment judgment might have been that it would be best to hold that security, just to come within the 30-percent provision.

We took the approach that we would not put that compulsion on them but, rather, for what we considered a more realistic approach, it did not make any difference whether you made money or lost money, whether you are a trading company or an investment company: The test should be, how fast do you turn over your portfolio?

Nobody is more conscious than we are of the difficulty of drawing the line; and yet we tried to take particular pains to indicate that.

I am not unmindful that the penalty is severe; and I indicated that if any other formula were submitted, why, that is the answer; but we feel, and I suppose Mr. Cabot would assume, that a stockholder ought to know the difference, he ought to know whether he is in an investment company or in a trading company.

I do not think he disagrees with our fundamental approach.

Senator TAFT. Mr. Cabot, what is your view on that same question?

Mr. CABOT. Yes. I cannot go along entirely with Mr. Schenker.

In the first place, the provisions on portfolio turnover in the Treasury regulations today are not hampersome to the industry in any way at all. Mr. Schenker is correct in saying that at times they might force a turn-over, to avoid the very provisions that are put in the bill.

However, Mr. Schenker neglected to mention that the provisions of this bill are that if we were to exceed our portfolio turn-over, then it is illegal, unless we have first obtained stockholder consent.

Now, Senator, picture the spring of 1933, when we went off the gold basis: We were conducting our affairs, running 60 percent in cash and Government securities and 40 percent in stocks; and we believed it became necessary and essential, overnight, to get practically fully invested. This law might make that illegal.

Senator WAGNER. How?

Mr. CABOT. Because if we exceeded our portfolio turn-over, by such a transaction—and that is the reason I have used this example here—without having first obtained stockholder intent, it would be illegal.

Senator DOWNEY. Mr. Chairman, may I come back to my question?

Senator WAGNER. Of course.

Senator DOWNEY. Mr. Cabot, in such a case as that, is there a remedy allowed, by which you could ask a waiver of the rule by the S. E. C.?

That was the question I asked.

Mr. HEALY. May I try to answer it, Senator?

There is a provision in here against changing any fundamental policy; and then the Commission is given permission to define the fundamental policy, giving weight to the elements pointed out in the bill.

It seems to me that a company finding itself in the situation that Mr. Cabot described, would not be held to change its fundamental policy—that is, the thing that you do in an emergency—it does not seem to me.

It seems to me that you give an extremely strict construction to that.

Mr. CABOT. We would not know what your fundamental policy is, in the first place; and what is fundamental to you and your associates today may not be so to your successors.

Mr. HEALY. Well, of course——

Mr. CABOT. Second, even if you did so interpret it, had we exceeded the 150-percent limitation without first getting the permission of our shareholders, that would be illegal.

Mr. HEALY. That would not be so, Mr. Cabot, if we had already established a rule or if this statute were written to say that an emergency action, in the face of unusual conditions, would not be a departure from fundamental policy.

Senator TAFT. In effect, the fundamental conception of this proposed law is that it shall be a law unless the Securities and Exchange Commission decides it shall not be?

Mr. HEALY. No.

Senator TAFT. No; there is hardly a provision in this proposed statute that the Securities and Exchange Commission cannot change, tomorrow, as a matter of law.

Mr. HEALY. I do not agree with that.

Senator WAGNER. I do not agree with it, either. In almost any law where there is any flexibility at all there is the provision that in certain circumstances the industry affected may receive permission to have an exception made, based on certain conditions and standards.

This is not a novel idea, whether or not there are certain exceptions that the Commission may have to take up with the industry.

However, Mr. Cabot, would you have any distinction between the ordinary trading company and a diversified company?

Mr. CABOT. I believe I would have some sort of distinction; and I will say that had the S. E. C. seen fit to allow the industry to go over the wording of this bill prior to its introduction to Congress, we could have straightened out a great many of these difficulties.

Senator WAGNER. However, Mr. Cabot, our committee is here for that purpose, you understand.

Mr. CABOT. Certainly.

Senator WAGNER. So we welcome your suggestions in that regard.

Mr. CABOT. Senator, if you now look at section 13 (a) of the bill, you will see what I am talking about. It there states, if I may quote:

SEC. 13 (a). No registered diversified investment company shall become a securities trading company or securities finance company, unless such change is authorized by the vote of a majority of its outstanding voting securities.

That is the provision that would have prevented us in 1933 from going from, say, 40 percent of stocks that are very conservative to 40 percent of stocks that would be more beneficial in a business recovery.

We could not have had that action, because of this section.

Senator WAGNER. Yet, I am sure you will agree that as a general proposition you ought not, without the approval of your stockholders, change the fundamental policy of your operation.

Do you think you should?

Mr. CABOT. No; I do not. I think you have got very carefully to define what "fundamental" is; and I shall cover that in a few minutes.

Senator WAGNER. Oh, do you cover that later on?

Mr. CABOT. I do, sir.

Senator WAGNER. Very well.

Mr. CABOT. It ought to be recognized, Senators, that in the last few years economic conditions have changed rapidly and dramatically. It is the duty of investment management to try to change their portfolio, as relates to their cash position and also as to the types of securities held, in order to conform with those changing conditions. The Federal Government should not assume the managerial function of restricting portfolio activity, and thereby take from shareholders a necessary safeguard. I assume that one possible objection in the mind of the Commission has been the result of the study of a few cases where excessive portfolio activity was more or less motivated by a desire on the part of somebody to obtain brokerage commissions. I submit that safeguards, such as any and all of the responsible people in the industry will agree with, are sufficient for this purpose.

Fourth, I am opposed to the arbitrary elimination of the right to borrow or create and maintain a reasonable amount of senior capital. Investment companies are in their essence nothing more than a group of individuals banded together for the purpose of diversification and expert management, and as such it does not seem fair that their borrowing power should by law be restricted to any greater degree than is the borrowing power of the individual. It must be remembered that the United States was in a large measure built on borrowed money, and had there been in other industries and activities of other times a restriction on borrowing, it would have been impossible to open the West and to develop the great natural resources that have made this country what it is today. If in the late 1920's this industry, like most others, over-indulged in the power to borrow, it should not mean that it alone should be singled out and prohibited from using credit in the future. An excess today in the direction of a prohibition on borrowing can well prove to be as unfortunate as excesses in the opposite direction a decade ago. The Federal Government wants to put to work the vast resources of unused capital and credit that lie idle today, with the thought in mind that with this capital at work people will be employed at useful production. It does not seem consistent with this thought to prohibit the legitimate use of credit by these investment vehicles. At times, a reasonable and legitimate use of credit can be of great benefit to the borrower, to the lender, and to the public at large, through the results of greater employment and industrial activity. Although we now have no present desire to borrow money or sell senior securities, for several years we did use our company's credit and borrowed money, to the distinct advantage of our shareholders.

Our fifth objection is that section 17, subsection (f) (1), makes it unlawful for any investment company in any of its contracts, bylaws, articles of association, charter, or "for any other instrument pursuant to which such a company is organized or administered," to have anything that "authorizes or purports to authorize the violation" of any rule, regulation, or order of the Commission. In other words, the Commission by this power can force any investment company to change or rewrite any bylaws, charters, certificates of incorporation, or any other instruments in any way that it may see fit, regardless of how long these have been in successful operation and regardless of how much the security holders may want them continued. I believe that these documents should be subject in their final determination

to the vote of the security holders and not to the actions of a govmental bureau.

Our sixth objection is that section 13 (b) requires that no change of any fundamental investment or management policy can be made without a vote of the majority of the outstanding voting securities.

This is the part about which you were inquiring, Senator.

Senator Wagner. Yes.

Mr. Cabot. I believe that there is great potential danger to the exercise of the best managerial functions, in this section—not because I disapprove of getting stockholders' consent to drastic policy changes but rather because the bill provides that the S. E. C. shall determine what is fundamental. They could say, for example—and I do not think they would—that to sell the shares of the General Electric Co. and buy the shares of the Texas Corporation represented a fundamental change and, hence, would be illegal without prior vote of shareholders. To obtain this vote for this and other transactions which might be more close to the border line of the S. E. C. interpretations of fundamentals, might well involve a time element that would preclude the possibility of making a rapid change in order to conform with the rapidly changing economy, and would therefore take away a managerial function which has often been used for the essential protection of shareholders.

Senator Taft. However, Mr. Cabot, suppose that you do represent in your original picture that you are investing in insurance shares, for instance.

Mr. Cabot. Yes, sir.

Senator Taft. There are trusts of that kind?

Mr. Cabot. Yes, sir.

Senator Taft. Then it would be a fundamental change in policy, I suppose, to go out and buy industrials?

Mr. Cabot. I should think so; and I have a suggestion, later on, for constructive legislation.

If I may put it in this way, to use this expression, this is the "destructive" part of my criticism; and I have some constructive ideas which I hope may be of some use to you; and one of them is exactly along the line of what you are now saying.

Our seventh objection is that under section 8, subsection (b) (1) (C), we are apparently asked, among a great many other things, to submit to the Commission and to our shareholders the "characteristics and relative amounts of securities and other assets which the registrant has acquired and proposes to acquire in the course of its business."

We submit that it is absurd to ask us or any intelligent manager what specific securities are going to be bought in the future. Obviously, we do not know; and if we were to make any statement as to what we were going to do in the future, and if we thereafter were forced to follow that statement, of course we could be put in a very bad situation.

The only thing we can be reasonably sure of is that conditions will in all probability change in the future as they have in the past and that any intelligent and honest management will be forced in the future, as in the past, to change its methods and types of investments to conform to changing circumstances. Hence, all any person can possibly say relative to future commitments is that they would be

made wholly with the thought in mind of best protecting and helping security holders.

My eighth objection: I believe that there is a size, depending upon general conditions and many other factors, beyond which it is inadvisable to go; but I do not believe it is wise to force by Federal legislation a definite size beyond which a company should not expand. If in the past there had been rigid limitations as to the size of other industries—although it is true that some difficulty and grief might have been avoided—it is equally true that the great growth of this country could never have taken place. For example, if years ago the automobile industry had been told that it could never expand beyond a definite size, it is probable that that great business could never have grown to its present importance. Other businesses are not regulated as to size, and I believe it is unsound to place arbitrary limitations on this industry, by law.

I believe that, as in the case of other industries, competition will take care of the situation; and when a point has been reached where the size of an investment trust is a serious adverse factor and a detriment to it, it will be impossible to increase it further.

My ninth and final objection is that I particularly object to the broad discretionary powers delegated to the Commission, which have been described to you in detail by Mr. Quinn, a previous witness.

I have now given some examples of those things in this bill that I think should be corrected. There are many others that I have not touched on, because they have already been explained by other witnesses, or will be explained by those witnesses to follow.

Senator Wagner. Now you are going into the constructive suggestions?

Mr. Cabot. Yes, Senator.

Senator Wagner. You did say that there was only one provision in this bill that affects your particular concern?

Mr. Cabot. Yes; other than the general rules and regulations that might be promulgated.

Senator Wagner. Have you told us about that?

Mr. Cabot. No, sir; I have not. I will be very glad to if you are interested. That is a provision respecting one of our directors. I had better not mention his name. Mr. Blank is a director of one our portfolio companies, and he would, under the provisions of this bill, have to resign and we would have to get somebody else. We think he is a very desirable director.

May I now outline my ideas as to the best way to achieve substantial protection of investors without hamstringing officers, directors, and managers in the exercise of their best investment judgment and in the handling of portfolio and management problems in the best interests of their security holders. I advocate a bill which will contain substantially the following provisions:

1. Registration of investment companies with the S. E. C.

2. Registration of officers, directors and other affiliated persons with the S. E. C. But this is not to be taken to mean that I am in favor of the portion of section 9 on this subject which gives the Commission unlimited power to obtain from such persons such information and documents as they may desire.

3. Complete disclosure to stockholders and to the S. E. C. of all matters affecting the investor. The amount and nature of such infor-

mation to be given does not, of course, lend itself to exact definition by statute, and the Commission should have a reasonable amount of power to issue rules and regulations for this purpose. I believe, however, that the powers vested in the Commission for this purpose in this bill are too broad.

4. The adoption of sound, and to the extent that it is desirable and feasible, uniform standards of accounting and auditing.

5. The establishment of standards, either by Commission rules or, preferably perhaps, through the National Association of Security Dealers, which are designed to reduce to a practical minimum the dilution of the equity of existing security holders in connection with the sale of securities of open-end companies.

Senator WAGNER. Would you mind stating that again?

Mr. CABOT. That has to do with——

Senator WAGNER. I know what it has to do with, but I did not quite catch your statement.

Mr. CABOT. It has to do with the establishment of standards, either by Commission rules or, preferably perhaps, through the National Association of Security Dealers, which are designed to reduce to a practical minimum the dilution of the equity of existing security holders in connection with the sale of securities of open-end companies.

Mr. Traylor will give you a great deal more on that at a later time, I believe.

6. A restriction on the issuance of senior securities and borrowing power only to the extent that it does not exceed the restrictions now applicable to individuals under existing Federal Reserve Board regulations.

Senator TAFT. What are those?

Mr. CABOT. I think, in common parlance, that the present Reserve Board regulations are about 40 percent. Is that right?

Mr. SCHENKER. That is the margin requirement. You want to make it analogous to the margin requirement?

Mr. CABOT. Yes.

7. Restrictions against improper relationships between investment companies on one hand and investment bankers and brokers on the other. In general, I believe in this connection that complete publicity and prohibitions against self-dealing will accomplish this purpose.

8. That officers, directors, and other affiliated persons should be subject to the same duties and liabilities as those imposed under section 16 of the Securities Exchange Act of 1934.

9. Reasonable diversification of portfolio securities. This is not to be interpreted to mean that certain companies should not be encouraged to engage in financing operations. Nor is this to be interpreted as an endorsement of the subclassifications now provided for in section 5 of the bill.

10. All management contracts and amendments thereto must be approved by stockholders; no assignments of such contracts to be made without similar approval.

11. Self-dealing between investment company and officers, directors, underwriters, and so forth, shall be prohibited.

12. All securities shall be held by depositaries approved by the S. E. C. Withdrawal of securities from depositaries shall be only according to rules and regulations to be laid down by S. E. C.

13. In any case where an investment manager or investment adviser as defined in the act serves more than one investment company, there should be a specific written agreement between the companies with respect to priority or prorata treatment in the execution of orders, in order to avoid any possible conflict of interest.

14. No substantial change in announced investment policy to be made without approval of stockholders.

Now, Mr. Chairman, I don't want to be too critical of the S. E. C., for I believe they have done a very fine and extensive pierce of work in the investigation of this industry and their reports upon it. Although I am no legal draftsman and am therefore unqualified to speak, I cannot but feel that this bill has been drawn hastily and under pressure. It appears obscure, redundant, and certainly over-complicated. I cannot but feel that had the S. E. C. gone over the wording of this bill with the industry prior to its introduction to Congress some, if not much, of the difficulty would have been avoided.

I hope that you and your committee, who have been so patient with us, will think that it is advisable to send this bill back to the S. E. C. instructing them to redraft it in consultation with representatives of the industry chosen by you and that you will indicate prior thereto those broad principles and restrictions that you would want in the bill so that direct conflicts of opinion that would occur between the Commission and the industry would be minimized. I thank you.

Senator WAGNER. Are there any questions of Mr. Cabot? (No response.)

We are very much obliged to you, Mr. Cabot.

We will take a recess at this time until tomorrow morning at 10:30.

(Whereupon, at 12 noon, a recess was taken until tomorrow, Wednesday, April 17, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

WEDNESDAY, APRIL, 17, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, Downey, Townsend, and Taft.

Senator Wagner. The subcommittee will come to order. Mr. Merrill Griswold, of the Massachusetts Investors Trust of Boston, will be the next witness.

Mr. Griswold, can you move up just one chair, if you do not mind being a little nearer?

Mr. Griswold. Certainly. Is this O. K. now, Mr. Chairman?

Senator Wagner. Yes; that is fine.

STATEMENT OF MERRILL GRISWOLD, CHAIRMAN, MASSACHUSETTS INVESTORS TRUST OF BOSTON, BOSTON, MASS.

Mr. Griswold. Shall I begin?

Senator Wagner. Yes; please.

Mr. Griswold. My name is Merrill Griswold. I am chairman of Massachusetts Investors Trust of Boston, which was the first open-end management investment trust organized in the United States.

I shall describe it very briefly. It was started in 1924. This was long before the 1928–29 speculative era, when so many trusts were organized. It was before the so-called fixed trusts had their heyday. Massachusetts Investors Trust was not "styled" for sales purposes to overcome objections to other types of trusts. It was organized because its founders felt that it could serve investors soundly. We believe its 16-year record justifies that belief. This trust and two similar trusts organized in 1924 and 1925 now account for about 40 percent of all the assets in the open-end management trust business.

Senator Downey. I did not quite follow that last sentence. Will you read that again, if you please?

Mr. Griswold. This trust and two similar trusts organized in 1924 and 1925 now account for about 40 percent of all the assets in the open-end management trust business.

Massachusetts Investors Trust is the largest open-end company in the business, having assets of over $120,000,000. It is not a corporation, but a true trust. The interest of the beneficiaries is represented not by stock, but by transferable certificates of beneficial interest, all

of one class and commonly known as shares. Its shares are redeemable on demand at net asset value. At the end of each quarter, it divides among the certificate owners the entire net income it has received from its securities, exclusive of capital gains and losses. Net taxable gains, if any, from the sale of securities are distributed only at the end of the year. The securities it owns are held by a bank, as custodian, under such strict custodianship that not even we ourselves, to use Mr. Schenker's picturesque phrase, could "back up a truck and take them away."

The trust is run by a board of five trustees assisted by an advisory board of five members. Because the testimony of the S. E. C. witnesses may have given you the impression that the investment trust business is populated almost entirely by scalawags and looters, I should like to file in the record a list of the names of our trustees and advisers, with a description of their affiliations. I think you will find them all to be men of character, ability, and high reputation. This, incidentally, is equally true of most investment trusts.

We welcome this opportunity to explain our point of view as to this proposed legislation. At the outset, I wish to say we do not oppose any legislation that may be necessary to prevent the recurrence of abuses in the open-end management trust business where existing laws are not adequate. We definitely do not favor this particular bill, however, which we consider unsound legislation in many respects that we and others will explain. We believe it should be largely, if not entirely, rewritten. I wish to be as helpful as I can to this committee on matters relative to open-end trusts. I shall be glad to answer any questions from you, and, when I have finished, I am willing to be cross-examined by the S. E. C. officials, if that will help you.

Senator WAGNER. Might I ask you a question right there without interrupting you unnecessarily?

Mr. GRISWOLD. Certainly, Mr. Chairman.

Senator WAGNER. I have noticed that several of the witnesses always began by saying, "We are absolutely against this bill," or something of that kind, and then would begin to tell some of the things they thought ought to be done. But many of the things which you and others say ought to be done are in the bill. For instance, Mr. Cabot indicated yesterday something of that same view—and therefore I want to ask you: Is it strictly accurate to say, just because one is against one phrase, or a phrase or two here and there, that he is against this bill? Or do you not mean to say there are many provisions in the bill which you are opposed to, but that there are other provisions in the bill that you favor, at least as to their objectives?

Mr. GRISWOLD. I favor some of the objectives of the bill but not all of them, and as I go along I am going to try to distinguish them.

Senator WAGNER. For instance, you may start out by saying, "This bill is terrible," or something of that kind, and I just wondered whether that was a general characterization of it.

Mr. GRISWOLD. No, sir. I think this bill is terrible.

Senator WAGNER. All of its provisions?

Mr. GRISWOLD. No. Two-thirds of its provisions.

Senator WAGNER. Very well. You may proceed with your statement.

Mr. Griswold. I might say right here, to anticipate for a moment, a committee of Parliament, that had to consider this thing over there, made a study similar to that made by the Securities and Exchange Commission, and they recommended changes by Parliament, but the provisions covering the basis of open-end trusts were contained in a schedule of about one and one-half pages.

Senator Wagner. Again yesterday evening I read the statement of Mr. Cabot, which I thought was a very clear presentation of his views, and then I read carefully also his constructive suggestions. It would require many pages to incorporate them in legislation if you wanted to do it carefully. But I am sure his suggestions impressed every member of this subcommittee, as they did me, because they were constructive suggestions and a recognition that something should be done.

Mr. Griswold. Yes, sir; and we have some specific suggestions which I will come to very shortly, and while they might take more than a page and a half they would not require 104 pages of a bill.

Senator Wagner. You may be right about that. You may proceed with your statement.

Mr. Griswold. Diversified management companies, as we compute them from Moody's classifications, comprise $554,000,000 for open-end companies, $517,000,000 for diversified closed trusts with senior capital, and $180,000,000 for closed trusts without senior capital. The balance of the industry represents various other kinds of investment companies which are not classified by Moody's as diversified companies. From these classifications, you will observe that the management of open-end companies comprises the largest division of the diversified management industry. Moreover, the open-end management trusts represent the only section of the industry that is growing substantially at the present time. We have available a list of the companies included in Moody's classifications. I think that has already been filed, Mr. Chairman. The statement was made by S. E. C. witnesses that the assets of investment trusts had shrunk by $3,000,000,000. To give you some idea of the experience of open-end trusts, I have compiled the figures for 15 open-end companies in Boston. Boston companies are accountable for about 60 percent of the assets of all open-end management companies. These figures show that these 15 companies received from the sale of all their shares up to December 31, 1939, the sum of $436,595,278; that they paid back in redemptions $122,389,796, leaving $314,205,482. There has also been paid back to the shareholders by these trusts since 1936, in dividends which were in the nature of capital distributions, the sum of $30,110,033, the source of which was clearly identified. That, Senator, was because of certain provisions in the 1936 tax law. This leaves $284,095,449, which represents the most for which the managers of these trusts should be considered accountable.

Now, let us see what the value of these trusts was on December 31. 1939. We find it was $262,800,631, a shrinkage of only $21,294,818, or less than 8 percent. This represents the aggregate result for all investors in these 15 trusts. Individual experience, of course, varied widely, because some holders who paid high prices for their shares in these companies show substantial losses, while others who bought their shares when market prices were low, show sub-

stantial profits. While we do not have the corresponding figures for the remaining trusts, we believe, from the information we have as to many of them, that they would show up equally favorably. These results, it seems to me, are very favorable, considering the unsettled conditions in recent years. And these figures, incidentally, take no account of the dividends paid to the public, which have amounted to millions of dollars. Our trust alone has paid out over $26,000,000 from investment income.

I mention these figures, not to prove that these trusts invest their money or perform their service any better than anyone else, but our stock seemed to sell much higher in 1929 than now, also sold mush lower in 1933. The point I wish to emphasize is this: By and large, in the aggregate, these trusts have been a good thing for the public because the public in the aggregate have not lost money in them.

In preparing these figures, we have followed the S. E. C.'s accounting method, which is to subtract the amount of redemptions from the amount received by the trust. The result obtained in this way is misleading and incorrect as applied to open-end companies, because it includes not only the losses of the trusts, but also the losses of shareholders who elected to redeem their shares at low prices. If a fair and proper method had been used, the result, favorable as it is, would have been much more favorable to these open-end management companies.

I am sorry to have to bore you with mathematical proof of this but it is most important that the record be set straight on this matter. I am going to say this slowly for you. A company sells 200 shares at $20 a share, receiving therefor $4,000. In the middle of the depression, shareholders redeemed half of these shares at $10 a share, the market having fallen, which reduces the assets of the trust by $1,000. Later, the market goes up again and each outstanding share is again worth $20. There are then 100 shares outstanding, which were issued at $20 a share and which are worth $20 a share, so that the assets of the company are worth $2,000. To see how much money has been lost, the S. E. C. method subtracts from the $4,000 originally received the $1,000 paid to the shareholders who redeemed, leaving $3,000, and in effect says that if the company is now worth only $2,000, $1,000 has been lost. It is true that the shareholders who sold out at $10, instead of holding their shares until they recovered their value, lost $1,000. It is not true that the trust lost $1,000. The Government figures for open-end management companies, therefore, do not really show the amounts lost by the trusts at all. They are, as I have said, a combination of the amounts lost by the trusts and the amounts lost by the shareholders who elected to sell out their shares when the market was low. It is not the trusts' fault if some of their shareholders unfortunately took such action.

This method of presenting the facts, when applied to open-end management companies, is just as silly as it would be to say that if 1,000,000 shares of U. S. Steel Corporation, for which investors in 1929 paid $250 a share, were sold on the Stock Exchange in 1932 at $25 a share, the U. S. Steel Corporation lost $225 a share, or $225,000,000. The U. S. Steel Corporation really lost $71,000,000 in 1932. It would be pretty tough to say that it lost not $71,000,000 but $71,000,000 plus $225,000,000 or a total of $296,000,000. I am not

making this criticism ill-advisedly; I have discussed this matter at length with our auditors, Lybrand, Ross Bros. & Montgomery.

Senator DOWNEY. May I intervene here, Mr. Chairman?

Senator WAGNER. Yes.

Senator DOWNEY. One difficulty in this hearing, with me, at least, is that I have not been able to be here all the time. I must admit that Mr. Griswold's statement in that respect seems to me to be sound, that to hold investment trusts liable for the loss incurred because some of the stockholders cash out at the bottom of a depression does seem to me to be an unfair criticism.

Senator WAGNER. We are not holding anybody liable for anything.

Senator DOWNEY. If the figures had been presented on that basis as showing losses to the investment trusts arising because stockholders did cash out at an unfortunate period of the general market——

Senator WAGNER. Of course nobody could be held responsible for that. There is more than that presented. I suppose the Securities and Exchange Commission will present other testimony. But we are trying to get both sides of this picture, and of course we begin by saying that many of these investment trusts were run honestly and efficiently and in the interest of the stockholders. But we are concerned with those who have looted; there is no question about that. What we are trying to ascertain is what we can do by legislation to prevent such looting, without in any way interfering with the operation of trusts which are operated in the interest of the stockholders and investors. That is what we are concerned with. So let us hear both sides, Senator, before we decide.

Senator DOWNEY. All I wanted to say was that I hope that Judge Healy will later rediscuss that point.

Senator WAGNER. On the question of losses?

Senator DOWNEY. Yes.

Senator WAGNER. There is no doubt that that will be done.

Senator DOWNEY. It is very hard to judge the soundness of any argument just by hearing one side. But I must admit that that sounds to me like a very sound argument.

Senator WAGNER. That is the reason that we are hearing these gentlemen, because we want to hear both sides. I have been enlightened a good deal by hearing both sides so far.

Mr. GRISWOLD. I want to say in that connection, Senator, with reference to our trust, that we had the figures recomputed by our auditors to see what difference it made—that is, by the two methods—and it made a difference in our trust of $6,000,000.

I recall that Mr. Paul C. Cabot once told the Securities and Exchange Commission—and right here let me say that the official to whom he told it is not among those present, so that this is no reflection on anyone present—I recall that Mr. Paul C. Cabot once told the S. E. C. that some of their statistics, in his opinion, constituted statistical monstrosities. I now claim that this method of figuring the losses of open-end management trusts is also a statistical monstrosity, and, therefore, misleading.

I hope I have not antagonized the committee by the criticisms I have made of some of the figures used by the S. E. C. I do not wish to imply that the S. E. C. in any way intended to create a false impression. I have merely presented these facts in order that the records might be clearer on this subject.

With respect to the importance of investment companies as a medium for the public's funds, one of the S. E. C. witnesses made the statement that one large investment trust held more common stocks than the 49 leading life insurance companies combined. This is a rather startling statement if you say it fast enough and don't think about it. But when you think about it, you will realize that it is about as sensible as saying that a village cobbler makes more shoes than the General Motors Corporation.

The fact of the matter, of course, is that because of investment restrictions imposed by various States in which they do business, life-insurance companies are prevented from holding stocks except in a most limited way. The Metropolitan Life Insurance Co., for instance, with nearly $5,000,000,000 of assets, has only 1.8 percent of its resources in either preferred or common stocks. The Prudential Life Insurance Co., with assets of $3,700,000,000, has only 2.1 percent of its resources invested in preferred and common stocks.

Statistical comparisons of this sort are unfair. Such unsound analogies as that just described lead me to suggest that statistics should be taken not with one grain of salt, but with three or four.

We respectfully suggest that before reporting legislation, the Senate committee acquaint itself with what has already been done in a legislative way respecting this type of company in Great Britain and in the different States, in order that we may profit by the experience and research which have gone into such legislation. Others will no doubt explain about the development which has taken place regarding this type of company in the numerous States. In some of these States, such as Ohio, Iowa, Michigan, and Wisconsin, substantial progress has been made in eliminating most of the abuses to which open-end management companies are susceptible. Because nearly all open-end management trusts are distributed on a national basis, these existing State regulations affect virtually the whole industry. For instance, trusts whose assets represent 80 percent of the open-end industry are registered in the State of Ohio and subject to its regulations.

There are some States outside of those four mentioned which have very good blue-sky laws; but those particular States are quite noteworthy.

In Great Britain open-end management companies are treated entirely separately from other types of investment companies. In my opinion, they should be treated separately in this country as regards a great many matters. In Great Britain, the Companies Act, which partially corresponds to our Securities Act, is not applicable at all to open-end management companies. The reason is that in Great Britain open-end management companies have never been organized as corporations. They have all been organized as trusts. The reason for that is that in Great Britain a corporation cannot legally buy in or redeem its own shares. If organized as a trust, however, it can. Such trusts being exempt from the Companies Act, the British Government arranged for the British Board of Trade, which is a department of the Government, to appoint in 1936 a committee to inquire into so-called unit open-end trusts and to report what action, if any, was desirable in the public interest.

This report, which not only contains a complete analysis of the subject but also makes many recommendations as to legislation, is only 59 pages long and will, we believe, repay study by the members

of the committee. It was evidently prepared in an impartial and fair manner. It in all cases explains both sides of all questions. Its recommendations are specific and concrete. It covers what are known as unit trusts. As many of the problems of flexible unit trusts are parallel to the problems of open-end management companies, we hope the committee will consider the recommendations made, which were in certain respects, we believe, more sound and more carefully thought out than some of the recommendations of the S. E. C. It is interesting to note that, after considering all the criticisms in the committee's report and considering to what extent legislation was necessary, the final decision of Parliament was that all that was needed was to make a very few simple provisions.

That seems to us concrete and workable legislation. It was decided that it was not necessary to encumber the act with constant and repetitious delegations of authority and the right to make rules and regulations on every conceivable subject having anything to do with such trusts. The drafting of simple legislation such as this way be more difficult, but at least it has the advantage of letting those subject to it know where they stand. The effort of Parliament was evidently to draft an act designed to heal a financial sore without hampering the pursuit of legitimate business.

We do not claim that the specific provisions of the British law are those which are necessary to cure the particular abuses that have arisen in this country, but we do claim that so far as the open-end management business is concerned, a few simple provisions could easily be devised which would prevent the sort of abuses which have taken place here. We claim that it is unnecessary to provide for every hypothetical abuse and possibility of temptation, at the expense of hampering legitimate business. For example, section 10 as a whole, is a prime illustration of this. We claim it would be sufficient for this bill to cover such matters as follows, in order to prevent abuses in the open-end trust business:

(1) Dealing with insiders as principals.

(2) Custodianship arrangements.

(3) Improper exculpatory clauses.

(4) "Selling down the river" abuses.

(5) Radial changes in the character of business, which provisions must, however, be more carefully drafted than in this bill.

(6) Audits and standard accounting principles, and adequate reports to shareholders.

(7) Proper limitations on borrowing.

(8) Restrictions on buying on margin or short-selling.

(9) Disclosure of source of dividends.

(10) Proper diversification of investment holdings.

(11) Provision for removal of improper management.

(12) Regulation of the sale and redemption of shares, which could be handled under the Maloney Act. I shall be very glad to tell you some time later exactly how this could be done.

Senator Wagner. You yourself have not attempted to draft anything, have you?

Mr. Griswold. I am not the expert who is testiyfing on that subject. Mr. Traylor will. It is the general belief of the industry that already under section 15 (a), I think it is, of the Maloney Act of 1934

it can apply to this abuse. If it is not absolutely clear to the S. E. C. that that is so, we are prepared to offer language which will make it so.

Senator WAGNER. Suppose they are not, as someone has referred to it, a member of the "Maloney Association." Then how do you control it?

Mr. GRISWOLD. On that point, Senator, I am going to ask you to talk to Mr. Traylor.

Senator WAGNER. Your suggestions are very interesting and rather comprehensive.

Mr. GRISWOLD. They are satisfactory to us.

Senator WAGNER. Yes; they are rather comprehensive. They go pretty nearly as far as section 10 does.

Mr. GRISWOLD. Oh, no, sir; they do not have anything to do with section 10.

Senator WAGNER. I did not mean as to the specific things, but in the way of attempting regulation they would be rather effective, I think.

Mr. GRISWOLD. As to the Maloney Act, Mr. Traylor will be prepared to explain that to the committee. That is something that we will be glad to cooperate with you on.

Senator WAGNER. It has worked out pretty well, I am told.

Mr. GRISWOLD. I am told that it has. I am in the management end. I am not in the distribution of securities.

Senator WAGNER. There were a great many objections lodged against it, that it was going to raise havoc in the industry, etc. But I understand that it has worked out very well.

Mr. GRISWOLD. So I am told.

Senator WAGNER. I have been called away, and I am going to ask Senator Hughes to preside. I am very much interested in your constructive suggestions, and I hate to leave at this time; but I will read carefully what you have to say about it.

(Senator Wagner withdrew from the hearing room and Senator Hughes assumed the chair.)

Mr. GRISWOLD. Shall I continue, Senator?

Senator HUGHES (presiding). Yes.

Mr. GRISWOLD. If adequate study is given to the drafting of legislation on these subjects, we believe that they can be adequately covered with a minimum of delegation of authority to the S. E. C.

Before commenting on two or three specific sections of the bill, I should like to add another word. The S. E. C. witnesses have told you that, although the Commission invited the industry to discuss the bill after the text was made public, the industry failed to cooperate. Although the time available was too short, prior to these hearings, to permit effective discussion of possible changes, I decided nevertheless to accept the S. E. C.'s invitation. I asked the S. E. C. staff whether or not they would like to "clear" a few of the points, in cases where I felt sure we could satisfy them that their language did not accomplish what was intended. They said they would be glad to, and stated that if I could convince them, they would say so and that we could thus eliminate certain controversial questions. I submitted two specific recommendations for their consideration, but it was impossible to get any answer from them. I am not blaming the members of the S. E. C. staff. How could they commit the entire Commission to a change? I mention this simply to indicate that the

suggested procedure was perfectly hopeless. So I was forced to give up the attempt.

I will now come to the specific subject of size.

The bill for Federal regulation of investment companies proposes that trusts which maintain diversified portfolios shall be arbitrarily limited to a maximum size of $150,000,000. Higher and lower limits are also set for other types of investment companies. In addition, by preventing the same group of individuals from serving as a majority of the board of directors of more than one trust, the bill limits the amount of funds under any one management.

As reasons for these provisions for limitation of size, the bill states that the public interest is adversely affected when investment companies—

1. Attain such great size as to preclude efficient investment management; or

2. Attain such great size as to have excessive influence on the national economy.

I do not know what facts, if any, the S. E. C. may have discovered in the course of its investigation that would tend to bear out either of the above contentions. My own experience and observations have convinced me that neither contention is justified, at least in the case of diversified companies.

It is my firm belief that the reasons for size limitation, as given in the bill, are not the real reasons for this provision. I say this because such reasons are too easily disproved. I believe that the real attitude of the S. E. C. is that size in itself is bad, and that this limitation has been imposed in accordance with preconceived social and economic theories.

This arbitrary size limitation is one of the most revolutionary provisions of this bill. It is uttterly without precedent. No other type of business has ever been subjected to such limitation. And the limits proposed are exceedingly low as compared with the size of other types of financial and industrial institutions. Are we to suppose that this bill is to set a precedent for the limitation, at some future date, of the size of steel companies, automobile companies, banks and all other types of business?

I noted, with great interest and some amusement, that when Mr. Schenker testified as to the reasons for this size limitation, he did not advance any of the reasons ascribed in the bill itself. Instead, he gave a number of brand new reasons, none of which had been previously discussed between representatives of the industry and the staff of the Commission. The S. E. C. has given various reasons in the past for its recommendation of size limitation. And when representatives of the industry have disproved these reasons, the Commission staff has advanced new reasons. This leads me to believe that the S. E. C. decided on the provision first, and then sought to find reasons to support it, with a notable lack of success, in my opinion, to date.

In their testimony before your committee last week, the S. E. C. witnesses made no mention of the effect of size on investment performance or of the possible influence of large investment companies on the national economy. The facts which I shall give you later will indicate clearly, I believe, why they abandoned both those original lines of argument.

Instead, the theory was advanced that limitation of size was necessary to protect investors against possible "runs" on open-end trusts, whose shares are redeemable at the option of their holders at any time. To make the point clear, the analogy of a run on a bank was mentioned.

I want to make it very clear to you gentlemen that there are certain fundamental differences between a bank and an open-end investment trust that make any such fears groundless. In the first place, an open-end company is not committed to repay a given number of dollars, as a bank is. It merely repays on demand a certain specified percentage of its assets, representing the ratio between the shares tendered by any investor and the total number of shares outstanding. Its obligations are at all times limited to its assets. Therefore, no open-end investment company such as ours can ever become insolvent.

Moreover, the investments of an open-end management trust, comprising a diversified list of highly marketable common stocks, are far easier to liquidate quickly and at fair prices than are the assets of a commercial bank, savings bank, or life-insurance company. And because open-end mutual companies are limited by the tax laws to the investment of not more than 5 percent of their assets in the securities of any one corporation, their holdings of any one issue never become so large as to be illiquid.

There is nothing in the 16-year record of the open-end trusts that gives the slightest reason for the belief that "runs" on them would take place. There were no such runs in 1929 or the early 1930's during the heaviest security liquidation that ever occurred in this country. There were no such runs during the violent market decline of 1937. The reason for this is fundamental. The shares of an open-end trust are not a bank deposit. They are an investment. And a difference of opinion always exists as to the attractiveness of any investment at any given moment. That's why there are always buyers and sellers. That is what makes a market. It is conceivable that all of the depositors of a bank might decide at the same time that it was wise for them to withdraw their funds. But it is inconceivable that all the holders of an open-end trust would simultaneously decide to liquidate their investment. The very market action that would cause some holders to liquidate would cause others to hold or increase their investment.

In 1937, during the severe decline in the stock market, the S. E. C. requested all open-end trusts to report each week the volume of their redemptions, and has asked all trusts to make such reports regularly ever since. The purpose of this, apparently, was to enable the Commission to ascertain whether redemptions increased heavily during declining markets and whether any liquidation of securities resulting from the need for redeeming shares had a depressing effect upon the securities market. In his testimony last week, Mr. Schenker said that one of the reasons for limiting the size of open-end companies was to protect the general level of security prices against the effect of liquidation caused by the redemption of open-end trust shares. But he quoted no figures from the S. E. C.'s 2½-year study of this question to support his argument. The natural inference is that the facts of this continuing study failed to support his contention.

In my opinion, there is only one way in which the funds of open-end companies can become illiquid. Strangely enough, that is when they are in the form of cash in the bank. If a trust with a substantial por-

tion of its assets in cash, placed all such cash in a single bank and that bank failed, an illiquid asset might result. In Massachusetts Investors Trust, which I head, we protect our shareholders against even this remote contingency by a policy that not more than 5 percent of our assets can be represented by a deposit with any one bank. In other words, we regard a bank deposit as an investment subject to risk and diversify such deposits on the same basis required in the case of our security investments.

In discussing the provision for limitation of the size of investment companies, Mr. Schenker also said that there was a correlation between large size and heavy investment losses. In citing examples, however, he switched from the open-end field to trusts of other types, such as holding companies and pyramided trusts. I should be very interested to see any figures the Commission has that prove that large size has been any detriment to investment performance in the field of open-end trusts.

Although no abuses as a result of size have ever occurred in the open-end trust business, the size limitation provided in the bill is obviously directed at this particular section of the industry. Mr. Schenker went to some lengths to point out that growth of assets, through appreciation, to a figure in excess of the specified maximum size was not prohibited by the bill. He said that there was no objection if a $10,000,000 company ran its assets up to $3,000,000,000 through appreciation of values. But growth through the sale of new shares to new investors beyond the specified figure is prohibited. If trusts beyond a certain size are undesirable (a theory to which I do not subscribe), what difference is there whether that size was attained through appreciation or through the raising of new capital?

In explaining this provision to your committee, the S. E. C. has stated that the size limitations imposed by this bill will not affect any existing company. It is true that no open-end company is presently larger than the maximum provided in the bill. But the size limit nevertheless seriously affects the future operations of any companies that are now near the specified limit. In the case of Massachusetts Investors Trust, for instance, with present assets of $121,000,000, we believe it will be very difficult to interest dealers in further distribution of our shares because of their fear that a rise in market values would place the trust in excess of the legal size, and thus limit the supply of securities they have contracted to sell. And although the sale of new shares is permitted as an offset to redemptions, dealers will be unwilling to sell on this basis because no continuous supply of shares is assured. Therefore, we feel it will be difficult, if not impossible, for us even to replace those shares redeemed in the future. And most important of all, general investor interest in our shares will be greatly lessened, merely because the imposition of an arbitrary size limitation will cause many investors to feel that the Government believes large trusts to be unwieldy and inefficient. This same fear of Government disapproval may cause many shareholders to liquidate their interest.

I should now like to explain why I believe that the two reasons for limiting size, as stated in the bill itself, are not valid. These reasons, you will recall, were (1) that large size resulted in inefficient operation, and (2) that large-sized investment companies exert excessive influence on the national economy.

Does large size injure or benefit the shareholder?

One of the earliest criticisms of the investment trust movement was that the cost of operation, from the standpoint of the shareholder, was high in relation to the amount of his investment. Reduction of the costs of the small investor has been the constant goal both of the Commission and of reputable trust managers.

It is now almost axiomatic in the trust business that operating costs decline proportionately as the size of a trust increases. The experience of shareholders of Massachusetts Investors Trust clearly proves this. With assets of $13,000,000 in 1932, operating costs were $11.02 per $1,000 of net assets. By 1939, when the trust had grown to $121,000,000, operating costs per $1,000 of assets had been reduced to $4.41, a decrease of 60 percent from the 1932 figure.

This advantage of size from the shareholder's standpoint is also clearly evident from a study we have made of 22 representative open-end companies with assets ranging from about $2,000,000 to about $50,000,000.

Senator Downey. That deduction assumes, of course, that the entire increase or decrease per thousand dollars in the cost of operation came from the increased magnitude of the operations, does it not?

Mr. Griswold. Substantially; yes.

Senator Downey. You feel confident that that is correct; that that was the major or sole reason for the decrease of costs? Perhaps the fact that you have been in existence longer and have become more efficient in management might have accounted for a part of it.

Mr. Griswold. Senator, whether a company is a one-million-dollar company, a ten-million-dollar company, or a hundred-million-dollar company, it has to maintain an office, pay rent, pay for long distance telephone calls, retain experts, clerks, stenographers, all the numerous expenses that go with it; and those expenses do not go up proportionately. We maintain what we consider to be a very good research department. We have a number of men who receive good salaries, and a large staff. If our trust were half as large, if we were to do the same kind of an investment job, we could not fire one single one of those people.

Senator Downey. Thank you.

Mr. Griswold. I was telling about the study which we made of 22 trusts. Their expenses per $1,000 of assets varied in 1939 from $6.80 to $14.48, as compared with $4.41 for the largest open-end company in existence.

It is our belief that further growth in the assets of Massachusetts Investors Trust would bring about still further reduction in proportionate costs of operation, with resulting benefit to all shareholders. Moreover, the economies to date have been more than relative, for Massachusetts Investors Trust, because of the growth in funds under its management, has set its trustees' fees at the same rate charged by most trust companies and private trustees in the State of Massachusetts for services as trustees under testamentary trusts. The rate of such charge is far less than the average for the investment trust industry as a whole.

Is size a handicap to investment performance?

It has frequently been contended that the small trust is better than the large trust because it theoretically has a greater agility in getting in and out of the market. This theory, however, is not borne out by

the operating records of the smaller trusts. Moreover, open-end funds are not trading companies seeking short-term speculative profits. They are vehicles for conservative, long-term investment.

A study of the comparative performance of the 22 open-end trusts just referred to for the 3-year period January 1, 1937, to January 1, 1940, shows that only one of these companies had a better investment performance than did the largest company in the field (based on liquidating values as of the two dates, with adjustment for dividends paid). Although the companies used in this comparison were representative, there may have been a few other companies whose performance was better.

Since this period covered a representative market cycle from high to low and with a partial recovery, it affords clear proof that the size of the Massachusetts Investors Trust portfolio placed it at no disadvantage as compared with smaller trusts.

Our trust has experienced no difficulty in buying and selling securities promptly and in orderly fashion. In the first place, total assets of a trust do not necessarily determine the size of its individual holdings. A number of trusts that are smaller hold larger blocks of certain individual issues. With minor exceptions, no block of stock held by Massachusetts Investors Trust represents as much as 4 percent of the issue in question; and holdings, in the average, represent less than one-half of 1 percent of the issues in question.

Massachusetts Investors Trust holds 115 separate issues, giving far greater diversification than most other trusts; and because of its over-all size, it can afford the research and other facilities necessary to supervise that number of issues. Moreover, further growth of the trust would not necessarily require any increase in the size of individual holdings, because out of the 2,200 stock issues available on the New York Stock Exchange and the New York Curb Exchange, there are many more than the 115 issues now held that would make suitable investments.

In connection with ability to liquidate holdings when necessary, it is important to remember that virtually all issues held enjoy active markets. In this respect, an open-end trust is in a much better position to realize on its assets promptly and at fair value than is a life-insurance company or a savings bank of the same or larger size, whose assets are in far less liquid securities in many cases.

There are many trust companies and certain investment advisory organizations throughout the country which supervise investments in amounts much larger than any investment trust now in existence. When such investment advisers and trust companies recommend sale of a specific security, the resulting selling orders may come simultaneously into the market in haphazard fashion from perhaps 100 or more different investors. Since this condition is apparently not a matter of concern, it is difficult to see why it should be in the case of an investment fund such as Massachusetts Investors Trust, where selling is orderly and controlled because it comes from a single source.

Like every other type of financial institution that permits withdrawals, the maximum size of open-end funds will be determined naturally by economic considerations. As the size of an open-end fund increases, the normal volume of liquidation by shareholders also increases. Thus, the excess of the volume of shares sold, over the volume redeemed, declines steadily, and the size of the trust is

limited at the point where sales finally do no more than off-set redemptions.

So convinced were our trustees of the inevitable course of this trend that 2 years ago they set a limit of 6,000,000 shares on the capitalization of the trust. The shares sell for about $20 apiece.

This was no tacit admission that a trust of larger size was cumbersome or undesirable. It represented merely a practical recognition of the difficulties of increasing assets beyond that point. Experience of the past 2 years shows that this expected balance between sales and redemptions is rapidly developing. The following figures clearly show the trend:

In 1937, 1938, and 1939 the dollar volume of shares sold was, respectively, as follows: 1937, $26,314,000; 1938, $14,384,000; 1939, $11,805,000.

In those same years the amount redeemed was, in 1937, $7,025,000; 1938, $7,883,000; 1939, $8,216,000.

In other words, we have approached the point in the last 2 years where our redemptions approximately equal our new sales.

Senator HUGHES (presiding). State that again, will you please, with reference to your redemptions?

Mr. GRISWOLD. Let me put it this way. Our redemptions are fairly constant. They are about 8 percent of our fund per annum. For example, in 1937 we paid back $7,000,000; in 1938 we paid back $7,800,000; in 1939 we paid back $8,200,000.

We have now reached a point where our new sales are approximately equal to that, or where these figures approximately equal our new shares. In other words, an open-end trust could never be a billion dollar company or a five hundred million dollar company, because redemptions, which are a fixed percentage, around 8 or 10 percent, get to be so large, when your fund gets to those big proportions, that you could not resell that amount of shares; and we therefore claim that economic conditions absolutely take care of this situation, and that there never will be an open-end investment trust with assets like life insurance companies and large banks.

Senator HUGHES. Thank you.

Mr. GRISWOLD. I will now deal with the social aspects. Even though large size results in no operating inefficiency or penalty to shareholders, we realize that big aggregations of capital funds must also be examined in the light of their social significance and from the standpoint of possibly undesirable concentration of control over the country's business and industry.

Will you pardon me, Senator? I omitted a small part of what I wanted to say. After reciting those statistics I should like to summarize and say the following:

We submit that the foregoing facts indicate that—

1. Large size reduces the investor's costs.
2. Arbitrary reduction or limitation of size will increase the investor's costs.
3. There are no serious operating or market problems involved in managing a large investment fund.
4. Size is no handicap to investment performance.
5. Economic factors will automatically limit the size of any mutual fund.

Senator DOWNEY. Mr. Chairman, I have to withdraw now, and I regret it very much. I shall read your testimony, Mr. Griswold.

(Senator Downey withdrew from the hearing room.)

Mr. GRISWOLD. Regarding this argument of undesirable concentration of control, we wish to point out that the basic theory of the mutual fund prevents any such fund from acquiring control of any business. Quite the contrary, such trusts do not invest more than 5 percent of their funds in the securities of any one company, and can invest in no more than 10 percent of the outstanding securities of any one company.

That is equally true of all diversified funds, closed or open. That is true today of the open-end trusts.

As a practical matter, Massachusetts Investors Trust has diversified its investments even more than required by these provisions. It has less than 4 percent of its funds invested in the securities of any one company, and its 10 largest individual holdings, in the average, represent less than four-tenths of 1 percent of the outstanding securities of the corporations in question.

It should be obvious, from the foregoing discussion, that Massachusetts Investors Trust does not desire, and in fact cannot use, its funds to subject corporations to its control or influence.

If it is feared that a group of open-end trusts under the same management might conceivably obtain control of other corporations through their combined holdings—this I should like to say is one of Mr. Frank's ideas—any such possibility can easily be prevented without arbitrarily limiting even the size of the group. For instance, (1) a maximum could be placed on the percentage of ownership in any corporation that can be held by any group of companies under the same or affiliated management, or (2) an individual director could be prevented from serving on all the boards of investment trusts which between them controlled more than a specified percentage of the stock of any corporation.

That is not against the law now. It is not in the bill, but it is entirely acceptable to us.

Opportunities for power and patronage. Entirely aside from the question of controlling other corporations, large aggregations of capital in the industrial field and elsewhere may have been criticized on the theory that their managements—if evilly disposed—are in a position, because of their size, to deal unfairly with labor or suppliers of materials. We point out that, in the case of open-end investment trusts, virtually no such opportunities for the abuse of the rights of others exist—regardless of the size of such trusts.

Organizations of this type do not buy large quantities of raw materials from suppliers, and hence cannot "grind prices down." Moreover, trusts are not large employers of labor. They buy nothing but securities, for which, like any other buyer, they must pay the quoted open-market prices. The only important business that they can award to others comes in connection with brokerage commissions on the securities they buy and sell; but even here, because such commission rates are standardized, there is no opportunity to "bear down" on those who render such services.

For all these reasons, we maintain that large aggregations of capital in the hands of open-end investment trusts are less likely to result

in the exercise of undue influence or power than in any other type of company. The managers of such trusts, although they may have large amounts of capital under their supervision, are so restricted by the very nature of the business and the rules under which they must operate that it is difficult to imagine any group that has less power to force its will on others.

In view of these facts, which are characteristic of most open-end funds, we submit that the criticisms that might be made regarding the concentration of a large amount of investment funds under a single management, under some circumstances, are not valid in this case.

Are there any questions, Senator?

Senator HUGHES (presiding). No; not now.

Mr. GRISWOLD. There is another matter in this bill that we should like to be recorded against, and which has not been discussed. That is the matter of voting rights of trust shareholders, under this bill.

This bill for Federal regulation of investment companies states that the interests of investors are adversely affected when investment companies issue securities containing inequitable provisions.

The language of the bill reads, "inequitable, discriminatory, or anomalous provisions, or failure to protect the preferences and privileges of their outstanding securities."

One of the purposes of the bill is stated to be the mitigation and elimination of such inequitable provisions.

In an effort to do this, the bill proposes that shareholders of open-end companies, including true trusts as well as corporations, shall be given the right to elect directors or trustees at annual meetings. In their application to true trusts, the proposed voting provisions are so sweeping as to require a complete departure from the basic principle under which such trusts operate. The basic idea of true trusts is continuity of management. A number of long-established investment trusts have been organized and built up on that principle. Their securities have been acquired by investors seeking continuity of management. In such true trusts, shareholders commonly have no voting rights. The trustees are permanent, subject only to removal by all or a majority of the other trustees, or by court action. In such trusts, many of the shareholders purchased their shares relying on the continuity of management.

It is argued that when investment company shares have no rights to elect directors or trustees annually, the result is inequitable because shareholders have no effective way of removing undesirable persons from control of such companies. The answer to this is that, in open-end trusts, the shareholders always have the right at any time to withdraw their capital at full liquidating value if they are not satisfied with the management. Moreover, the threat of such withdrawals because of bad management is the best incentive there possibly can be for good management.

The voting provisions suggested in the bill would outlaw most of those investment companies that are organized as strict trusts, and whose continuity of management is assured by vesting control in the trustees rather than in the beneficiaries. The voting provisions required in this bill constitute a death sentence for true trusts.

Trusts that are operated by investment counsel firms are typical examples of cases where investors want continuing management by a

particular group of individuals. Some of these trusts operated by investment counsel firms have been organized as true trusts in order to assure this. Another well-known type is the "common trust fund." These are operated by banks and are expressly exempt from this proposed act.

Investors in true trusts, in effect, choose their own trustees, at the time they buy their shares, just as an individual does when he appoints a trust company or chooses an investment counsel firm to manage his investments. The only difference is that, in the case of the open-end investment trust, the funds are commingled and the client's claim is represented by redeemable shares.

There are plenty of investment companies organized as corporations, with annual election of directors, in which an individual can invest if he prefers. There is no good reason why the type of investment trust in which shareholders do not have a vote to elect trustees should be outlawed. There is every reason why investors who prefer this type of trust, because it assures them the continuity of a specific management, should be allowed to choose it.

The type of investment company organized as a trust, rather than as a corporation, has had a long and honorable history in the management of real estate, especially in Massachusetts and in Illinois, as well as in management of securities. The oldest well-known investment trust of this character is the Boston Personal Property Trust, which has existed and prospered since 1893, or nearly 50 years. Purchasers of investment-trust shares are accustomed to this type of trust and have been willing to rely upon the integrity and judgment of trustees of recognized standing. In many cases the assurance of permanent management is definitely preferred to the plan of annual elections, whereby the management may be shifted from year to year. We question whether the Government's attitude should be so paternalistic as to deny the investor such a choice.

An individual who places his funds in a voluntary trust administered by a trust company can likewise terminate the trust if he is dissatisfied with the performance of the bank in question; but he is not entitled to force a change in the management or policies of the bank, which may be eminently satisfactory to most of the institution's other trust customers. Neither can a change in trusteeship be brought about by the beneficiaries of a common trust fund, which is a special kind of open-end investment company operated by banks and recognized under both Federal and State statutes. This same principle is also well established in the investment counsel field. In dictating by law, for the protection of investors against the people they employ to manage their investments, why differentiate between any of these examples?

Apropos of recent foreign difficulties, I might say, "Why should we be taken into protective custody," in respect to this and many other provisions of this bill.

If, however, the existing rights and protections are not deemed sufficient, we should have no great objection to giving the shareholders of true trusts——

Senator Hughes. Do you call them "true trusts"?

Mr. Griswold. I have been commenting on the S. E. C.'s plan.

Senator Hughes. I say, do you call that a true trust?

Mr. Griswold. Yes, sir; we are a true trust. We are exactly like a testamentary trust, except that our shareholders have certificates.

Senator Hughes. I have often heard reference to the Massachusetts Trust as something that was created or devised by Secretary Olney.

Mr. Motley. I think Secretary Olney very likely was the man. I think he was the man who drew the declaration of trust for the Boston Personal Property Trust, which is the oldest trust going.

I am not absolutely positive of that fact; but he was practicing at about that time, and I think I remember being told that he did draw the declaration of trust for the Boston Personal Property Trust. Incidentally, the Boston Personal Property Trust is exactly the same type of trust as these.

Senator Hughes. Yes; that is right.

Mr. Griswold. I was saying that if the existing rights and protections are not deemed sufficient, we should have no great objection to giving the shareholders of true trusts the affirmative right, by a proper majority, to remove trustees. There is a vital difference, however, between this "right of removal" and the provisions of the bill for "annual election" of trustees. If the right of removal is given, it seems to us that no complaint could any longer be made that the securities of such a true trust contained anything inequitable in this respect or failed to contain an equitable provision on the matter.

If such a right of removal by shareholders is to be given, it should, however, require the vote of a full majority of all outstanding shareholders, if not of two-thirds of all outstanding shares. The reason for saying this is, that in the case of any true trust, the whole idea of which is permanency of management, a change in management is a major matter vitally affecting the interests of those shareholders who bought into the trust in reliance on that kind of a management.

A change in management under such circumstances should not be lightly treated, as it would be, for example, if only the majority of a quorum were necessary—which would only be 26 percent if a bare majority attending a meeting. Matters that are major in the case of corporations, such as the sale of all of the company's assets, or a change in the general character of the business, or an increase or change in the capitalization, usually require the affirmative vote of a majority or of two-thirds of all of the outstanding shares, in order that the rights of minority shareholders, who went into the corporation on a certain basis, shall not be lightly overruled. Nor do we have any particular objection to a provision for annual or special meetings of the shareholders of true trusts, for purposes of allowing shareholders to vote on such matters as changes in the character of the business, or the removal or appointment of auditors, if this is considered wise. We do not consider it wise, ourselves; but it is a small point. At such meetings, the trustees could present the accounts of the trust, and shareholders should be given full opportunity to inquire into the management of the funds.

Mr. Motley has reminded me that I should explain one thing to you, Senator, which applies to these true trusts, of which there are a number in the business. There has been a lot of talk about "selling down the river." Where there is a management contract, the people who have owned the stock in the management corporation have sometimes "sold it down the river"; or where there has been an equity

stock, the people owning a majority sometimes have sold it to unscrupulous people—which is one of the evils we are all anixous to eliminate.

In these open-end true trusts, they are run by trustees. There commonly is no management contract, and there certainly is no equity they could sell; because the shareholders all over the country own that, and the trustees own only a very small percent.

It has been suggested that the trustees might sell out their office—in other words, that you could come to me and offer me so much money, and that I would resign, and the other trustees would elect, we shall say, Mr. DeRonde to take my place, and then another one of us would resign and we would elect some other man; and in that way we could sell out.

The answer to that is that it is absolutely impossible for us to do that; because under the common law respecting fiduciaries, if we were crooked enough to do it, the funds we would receive would themselves belong to the company, and we could not keep them; and if we did keep them, we would be guilty of an embezzlement. In other words, we cannot "sell down the river" if we want to—and we do not want to.

Does that answer that sufficiently?

Mr. Motley. Yes; I think so.

Mr. Griswold. Mr. Motley has also reminded me that I should state that there are several other true trusts, in the strict sense of the phrase, that are represented at these hearings and whose representatives intend to speak on this very point. I believe that the head of the Boston Personal Property Trust—which was Mr. Olney's trust—is here. They no doubt think that I go altogether too far in offering to compromise by giving the right of removal. They think that the people buy their trusts with the idea of absolute permanency in management; and I have no doubt that they will give you very good reasons why they think so.

We have one other short memorandum we can give you at this time, Senator, or not—as you please.

Senator Hughes (presiding). Do just as you like about that, Mr. Griswold. My understanding with the Chairman is that we shall continue on until probably 20 minutes after 12, or something of the sort; and he may be back in the meantime.

I think he then will have to go to the floor of the Senate; I do not know what plans he has made for the afternoon.

Mr. Griswold. Well, suppose I give you a rather short further statement.

The reason I say that is that the next speaker is going to have a very long speech to make, which would not be covered before half past 12.

Senator Hughes. Then we had better take that in the afternoon.

Mr. Griswold. Very well. Senator Hughes, I shall give you a short memorandum on one other matter. I am very sorry that your associates are not here to hear some of this, and I hope they will read it.

Senator Hughes. Yes; I hope they will, too.

Mr. Griswold. This memorandum has to do with bureaucratic censorship and red tape.

In the introduction to the Wagner-Lea bill, which proposes Federal regulation of investment companies, it is stated, as one of the reasons for the bill, that the national public interest and the interests of investors are adversely affected when investors do not receive adequate accurate, and explicit information, fairly presented, concerning offerings of securities.

There can be no quarrel with this point of view; but it has commonly been assumed that this was what the Securities Act of 1933 was for. The 1933 act requires that prospectuses be true to the smallest detail, contain all material facts, and be free from misleading statements. It also provides that it shall be against the law to transmit by mail any untrue statement in order to sell a security. It gives the S. E. C. the right to bring injunctions or refer such matters to the Attorney General for criminal proceedings.

Whatever other abuses there may be, one would think that the S. E. C. already had enough authority to protect the public against misleading statements and other frauds of that nature; but even though every investment company which offers its securities to the public is directly or through an underwriter already covered by the Securities Act of 1933, the Wagner-Lea bill proposes to subject the investment trust business to further bureaucratic censorship and endless red tape in connection with sales literature.

We are in entire sympathy with all sensible efforts to protect the interest of the holders of investment trust shares; but we do not think that end will be accomplished by snarling the entire business in complicated requirements involving registration, examination, reports, censorship, too iron-clad accounting methods, filing of literature and correspondence, and other complicated procedure. The type of thing proposed by the Wagner-Lee bill is bureaucracy for its own sake.

In this connection, Mr. Leon Trotsky, whose opportunities to watch the workings of bureaucracy have been almost unparalleled, recently said of what is going on today in Russia:

> The monstrous centralization of the entire industry and commerce from top to bottom, such as the compulsory collectivization of agriculture, was determined not by the needs of socialism but by the greed of the bureaucracy to have everything without exception in its hands.

Although the sale of investment trust shares is already regulated under the Securities Act, the proposed Wagner-Lea bill would make it unlawful for an investment company or its underwriter to employ in the sale of its shares any pamphlet, circular, form letter, or other literature unless it has been filed with the registration statement as an accompanying document, or as an amendment of such registration statement. Not satisfied with this, the bill then goes on to provide that every investment company, underwriter, and dealer shall make, keep, and preserve such accounts, records, memoranda, and correspondence as the Commission may prescribe, all of which shall be open to examination by the Commission. Thus will the S. E. C. undertake to tell everyone connected with the investment trust business just what correspondence and memoranda he must make and keep, so that there will be plenty of material available for any "fishing expeditions" that the S. E. C. may wish to conduct.

The chief objection to the filing of all literature and form letters with the S. E. C., except for the red tape and inconvenience involved, is that there can be no purpose in it unless the Commission establishes

a special department to censor every bit of literature issued by the industry; and if a censorship shall be established over all literature, not merely prospectuses, employed in selling investment trust shares, why not a censorship over all such literature put out in connection with the sale of all securities of every type in the United States?

Another objection to this filing of sales literature is that they say it must be filed as part of the registration statement. The result of that will be that even in an investment trust which has nothing to do with the selling and which is entirely segregated from the selling organization, each and every director of the investment trust itself will be liable for every misleading statement that may be made not by themselves but by the people who sell their shares.

It would mean that each director would be liable to punishment in the amount of 1 year in jail, if not 2, if the slightest mistake is made; because as underwriter, he is liable for every misstatement made, as I understand it, which is part of a registration statement.

This will mean endless delays. How can our selling house get out sales literature if they first have to refer it to us, as trustees, and then we have to refer it to our attorneys—and then, I might add, have it filed with the S. E. C.?

If the S. E. C. has to approve all the literature—and I suppose they do not want it unless they want to approve it—how long is that going to take?

Most of these investment-trust houses who sell the shares get out literature every week, in the way of weekly bulletins to all their dealers. There are thousands of dealers, all over the country, who receive articles not only about the investment trust, but about the course of the stock market and the effects of the war in Europe, and such matters as those. If this bill goes through, I suppose that will just have to be referred to us, and then we shall refer it to the lawyers; and that will be the end of that kind of thing. It will be utterly impossible, and it is utterly ridiculous.

Although the S. E. C. has no right to criticize such sales literature, from letters, and so forth, unless they violate the law, the arrangement would undoubtedly result in constant efforts by the S. E. C. to make changes in the texts of such documents, resulting not only in delay, but in outright censorship. No such requirements exist in the case of other types of securities, and it is difficult to see why the investment trust field has been singled out for such censorship.

Outlined below are some of the many ways in which the Wagner-Lea bill imposes bureaucratic authority and red tape on the investment trust business. Some of these provisions may be necessary to the administration of such an act, but many seem entirely unnecessary, while others represent useless duplication of procedure already required under existing laws.

I shall just state a few of these, to show you what we are going to be up against in this business:

First, all investment companies must qualify for one of the "classifications" specified in the bill.

Second, all investment companies must register with the S. E. C.

Third, all officers, directors, managers, investment advisers, underwriters, and distributors of investment companies must register individually with the Commission.

Fourth, all literature, including form letters, issued by an investment company, or its underwriters, must be filed in advance with the S. E. C.

Fifth, investment companies, and their advisers, underwriters, and distributors will be required to make periodic reports, and special reports when requested, on any matters pertaining to their business.

Sixth, the S. E. C. is empowered to specify the form and content of the reports sent by investment companies to their own shareholders.

Seventh, directors and officers of an investment company must report to the S. E. C. each month any transactions they have effected in the shares of the company.

Eighth, all individuals affiliated with an investment company, including officers, directors, and investment advisers, must report each quarter to their own board any purchases and sales they have made in security issues that weie purchsed or sold by the company in the same period.

Ninth, the S. E. C. can require the making and keeping of accounts, books, memoranda, correspondence, and other records in specified form, and can prohibit the keeping of any records other than those approved. This applies not only to investment companies, but to underwriters and investment advisers as well.

Tenth, all books, papers, memoranda, correspondence, and so forth are subject to examination by the S. E. C. at any time.

Eleventh, the S. E. C. in its discretion, can determine the amount of sales commission on trust shares if it deems existing commissions to be excessive.

Twelfth, the S. E. C. has complete authority to regulate the prices at which an investment company can buy or sell its own shares.

Thirteenth, the S. E. C. is empowered to determine not only the accounting principles to be followed by investment companies, but also the actual detailed methods to be used.

The opportunities, listed above, for bureaucratic control and censorship, already exist under the terms of the present bill and the specific delegations of authority it grants to the S. E. C.; but because the Commission is also given blanket authority to make any further rules or regulations it deems "necessary or appropriate" to administer the bill, no one can tell in advance how many more bureaucratic controls will finally be added.

That is all I have to say, Senator. I should also like to submit for the record a list of the trustees and members of the advisory board of the Massachusetts Investors Trust.

(The list of trustees and members of the advisory board of the Massachusetts Investors Trust is as follows:)

Trustees and Members of the Advisory Board of Massachusetts Investors Trust

trustees

Merrill Griswold, chairman; L. Sherman Adams, Charles F. Rowley, Dwight P. Robinson, Jr., Kenneth L. Isaacs.

advisory board (with some of their affiliations)

Charles Francis Adams: Formerly Secretary of the Navy; formerly treasurer of Harvard University; State Street Trust Co., Boston, chairman of board; American Telephone & Telegraph Co., director; General Electric Co., director; John Han-

cock Mutual Life Insurance Co., director; New York, New Haven & Hartford R. R. Co., director; United States Smelting, Refining & Mining Co., director.

Roger Amory: Bigelow-Sanford Carpet Co., Inc., director; Boston & Maine Railroad, director; Consolidated Investment Trust, trustee; National Rockland Bank of Boston, director; Provident Institution for Savings, of Boston, trustee; State Street Trust Co., Boston, director.

James L. Richards: American Sugar Refining Co., executive committee, director: Boston Elevated Railway Co., executive committee, director; Boston Wharf Co., director; Consolidated Gas Electric Light & Power Co., Baltimore, director; Eastern Gas & Fuel Associates, executive committee; Massachusetts Bonding & Insurance Co., chairman executive and finance committee, director; Merchants National Bank of Boston, member, executive committee, director; New York, New Haven & Hartford R. R. Co., executive committee, director; United Drug Co., executive committee, director; Waltham Watch Co., executive committee, director.

Henry B. Sawyer: Chicago, Wilmington & Franklin Coal Co., director; New York, New Haven & Hartford Railroad Co., trustee; Suffolk Savings Bank for Seamen and Others, Boston, member, board of investment and trustee.

Oliver M. W. Sprague: Formerly economic adviser to the Bank of England; formerly special assistant to the Secretary of the Treasury; professor of finance at Harvard University Graduate School of Business Administration; foreign adviser, General Motors Corporation, National Shawmut Bank of Boston, director.

Mr. Griswold. That is all, thank you, Senator.

Senator Hughes (presiding). Thank you, Mr. Griswold. We are glad to have heard you.

I understand it will be satisfactory if Mr. Bullock talks during the balance of the morning session. We shall probably be here until half past 12 or a few minutes after that.

Did you want Mr. Traylor to be the next witness?

Mr. Griswold. No, Senator; we were going to ask Mr. Bullock to speak next, since he has a fairly short statement to make. We shall ask him to present his statement now, if you will hear it at this time.

Senator Hughes. Yes; we shall do that. Then this afternoon Senator Wagner will be here.

Mr. Griswold. It is very important to hear these, if possible.

Senator Hughes. Yes; but I have to go on the floor of the Senate at half past 2.

STATEMENT OF HUGH BULLOCK, VICE PRESIDENT, CALVIN BULLOCK CO., NEW YORK CITY

Senator Hughes (presiding). Mr. Bullock, will you give your full name, for the record, please?

Mr. Bullock. Mr. Chairman, my name is Hugh Bullock. I am vice president of Calvin Bullock, a New York joint stock association.

First, Mr. Chairman, let me say that in desiring maximum protection for investors, the S. E. C. and ourselves have identical objectives.

It is tragic when small investors lose money as a result of financial panics or economic depressions. It is outrageous when any loss occurs as a result of unsound practices or outright dishonesty on the part of those in a position of trust. To keep our perspective, however, we must remember that, after 1929, the market value of stocks listed on the New York Stock Exchange declined from a high of $89,000,000,000 to a low of $16,000,000,000, or more than 80 percent, and that investment companies are, for the most part, organizations that deal in general market securities.

As to looting in the so-called open-end investment company field, based on what I can find on reading the comprehensive reports of the

S. E. C. study, an amount equal to only a fraction of 1 percent of the present value of the open-end companies' assets was affected.

No law can prevent losses to investors in times of depression, and I fear that no legislation can be devised always to catch the outright crook; but if any law can be passed to eliminate unsound practices in an industry which I think, when properly conducted, fills a great public need, I am for it. I am anxious to do anything I can to have all investment companies placed on the same high plane that many of them occupy. I think it would be a great public service; because I believe that a well-managed investment company is the best medium for investment of any vehicle yet devised.

We are deeply conscious of our responsibilities in managing other people's money. There are principles expressed in the present bill that we have believed in for a long time. There are some, however, that go far beyond any philosophy that we are in a position analogous to that of a trustee of other peoples' money.

To save the committee's time, some of us in the open-end industry have divided up subjects and will confine our remarks primarily to one. The subject on which I want to give you our viewpoint is that of managing more than one investment company.

The bill requires that a majority of the board of directors of an investment company be persons independent of its principal underwriter and manager; but the bill goes further and tells you that when an investment company has such a board with an independent majority, that board cannot also constitute the board of another investment company, unless one of the companies is a subsidiary of the other. It also provides that an investment officer or a manager of one trust cannot serve as such for another. In other words, it requires every company to have a separate directorate, investment officer, and manager from every other company. The same people cannot run more than one trust.

Why, in all circumstances, shouldn't the same independent group of people have the responsibility of managing more than one investment company? Section 10 says they cannot. What conceivable theoretical objection could there be?

We can only vaguely imagine two: The first is that when purchases or sales of identical securities are made for two or more trusts, the one whose orders are placed first may gain an advantage at the expense of the others. The problem can be solved, however, by the simple expedient of combining orders and making a proportionate allocation to each investment company.

Of course, if the investment companies had different portfolios and differently stated investment objectives, no one could suggest a conflict by reason of being managed by the same group.

I have heard of one other highly theoretical objection, to wit, that if the same group managed several investment companies, they might have too much influence over some company whose shares were included in all the trusts' portfolio. For example, assume that 10 trusts, managed by the same people, each owned 5 percent of a corporation's stock: This group would then control the portfolio company.

To be sure, all this is highly theoretical, because a compilation covering 51 investment companies, prepared by Barron's, showing the stocks jointly held by 18 or more investment companies as of

the close of 1939, indicates that in only four cases do the combined holdings of the 51 trusts account for more than 10 percent of the stock of the corporations in question.

I am told that if the three largest open-end trusts in Boston today were operated by a single management, their combined holdings in any one corporation would represent, at the most, less than 4 percent of the outstanding stock of that corporation as far as 98 percent of the companies represented in their combined portfolios are concerned. In nearly 50 percent of all cases, such combined holdings represent less than 1 percent of the outstanding stock of the corporations involved; and the highest percentage of ownership involved is only 7.1 percent.

However, if it is still felt that the operation of several trusts under one management might lead to the danger of the control of corporations, then we submit that there are better ways to prevent any such situation than by saying the same group cannot manage more than a single fund. For instance, as Mr. Griswold suggests, a maximum might be placed on the percentage of ownership in any corporation that can be held by any group of companies under the same or affiliated management; or an individual director might be prevented from serving on all the boards of investment companies which, between them, controlled more than a specified percentage of the stock of any corporation.

What are our objections to a prohibition preventing the same group from managing several investment companies? Our first objection is the fact that several existing arrangements would have to be disturbed, through the necessity of getting a number of new directors. Competent directors are not easy to secure, particularly in view of another unfortunate provision in the proposed bill which effectually prevents, in the case of a diversified management investment company, a director of such company being a director of any company in the portfolio. We, too, want to see developed—as well as the S. E. C.—in this country a class of executives and directors who will make of this industry of investment management a profession; and we do not want hurdles put in the way.

Our second objection is that the only conflict we can possibly see would be where we take the case of a group of trusts run by different people receiving advice from the same investment adviser or investment counsel—which is perfectly allowable under the proposed bill. We assume such advice would be generally followed, otherwise such investment adviser or counsel would not be employed. Moreover, we assume his advice would be very similar, to all of his clients. Therefore, you would have the curious situation of different managements competing in the market to buy or sell the securities that such adviser suggested, and, for instance, bidding up the price of a certain security, one against the other. This scarcely seems for the best interests of stockholders.

Our third objection to any proposal that the same group could not manage several investment companies is that we do not see any conceivable conflict. Mr. Smith testified that he personally managed several personal trusts. You and I know that the same bank manages thousands of individual trust accounts. Any man who suggests that there is a conflict with respect to the trustee of a certain number of personal trusts or a bank with a large number of trust accounts, just is not realistic.

You see, my firm learned its trust lessons in England many years ago. The dean of the investment-trust company profession there, the man who attained a degree of eminence that many believe will never be equaled again in this profession in any country—and almost certainly would not be in this country, if this bill became law—was the late Robert Fleming. My father reminded me on Sunday that Mr. Fleming had told both of us in 1926 that his firm managed 23 trusts with assets of over a quarter of a billion dollars.

That does not quite check with a booklet I have here that discusses the British investment-trust groups. Tables are given showing certain groups—the number of trusts and the capital of each. The Fleming group apparently totals 15, with 25 million pounds, capital. A footnote, however, reads:

According to Linhardt, R. Fleming & Co. is estimated to exert an influence in some form or another on companies—

which, of course, means investment companies—

with more than £110,000,000 total assets.

That is more in line with a message dated April 13, 1940, to me from our London manager, which reads as follows:

Replying to your inquiry as to the extent of the Fleming trusts, the most accurate estimate I have received in some time was from an independent London stock broker who specializes in trusts.

He then stated that the Flemings either managed exclusively or have one or more of their people on the boards of 34 trusts, with assets estimated at £100,000,000.

Suffice it to say, we have excellent authority for the fact that British practice is for substantially the same people to manage trusts in groups, and these groups attain large size. The booklet I was quoting from is prepared for the Securities and Exchange Commission, and submitted as part of their study to Congress. It is on British investment companies. May I read another brief passage from this booklet:

Certain advantages attach to the creation of new trusts instead of an increase in the capital of existing trusts. For instance, the capacity of the market for issues of an existing trust is in practice often limited. Securities of new associated companies have a special appeal to the investor. The regulations in the articles of association can be varied in a new trust according to new requirements. Investment policy can also be varied to suit the general lines of the trust group's policy.

Then, Mr. Chairman, somewhat higher on that same page is this statement—and I quote:

These investment trust groups were formed by organic growth, not by the purchase of control of existing trusts. It has proved easier to use the same amount of money which would be necessary to purchase controlling interest in an investment trust, in promoting a new trust, the portfolio of which can be arranged according to the ideas of the founders. The normal way by which such a group is formed, therefore, is successive promotion by the same founders.

I want to clear the record with respect to some testimony that came up the other day regarding organization by one firm of six trusts in one year. Incidentally, the year of organization is an interesting point: They were not organized in 1929 or in 1939, but in the low year of the entire depression, to wit, 1932; and there were not six trusts, but five; one represented a consolidation.

However, Senator, it is not the number that has any significance. The essential point is the experience of investors.

May I read a letter that arrived, unsolicited, from my father to me, dated April 15th:

I understand we are accused of forming five investment trusts in 1932. We did this to take advantage of the lowest prices in years, and also to offer different classes of investors the type of securities best suited to their needs.

In the 8 years since then we have formed no trusts.

Here is the record:

This group of five neither buys on margin nor sells short.

All these companies pay dividends quarterly, have never passed a dividend, and have no debts.

Cash on hand April 8, 1940, $4,500,000.

If an investor had put $1,000, or any fixed amount, in each company at the initial offering price, and had held his shares, he could sell them today at a profit in each and every case, after receiving an average return per annum of a trifle over 7 percent on his original investment.

Directors in the 5 companies outside our office, are also directors in over 100 other companies, with which we have no connection.

The five companies have over 59,000 stockholders.

Total dividends paid, $19,396,000.

If you know of a group with a cleaner record, perhaps you can persuade them to go on our Board. We are always looking for talent.

If I remember correctly, the other day Senator Frazier expressed surprise that any one firm would organize 10 or 12 trusts over a period of time. My firm did, and is proud of it. We learned our lessons in England; and, as I have pointed out, it is the English system to organize and manage a group of trusts.

Again, let us look at the essential thing, namely, what was the experience of investors in these trusts?

I should like to read one page of my testimony given 4 years ago at the S. E. C. public hearings—and then, Mr. Chairman, I am through.

I should like to point out that the majority of our trusts show profit to the original investors today. One thousand dollars originally invested in every 1 of the 11 trusts we have formed, namely, an original total investment of $11,000, today would be worth $11,750-odd. Meanwhile, investors have received over $3,000 in dividends, or a total gain—adding income to appreciation—of about 35 percent; and today 40,000 stockholders of our company have a profit in our shares. No company under our management has ever passed a quarterly cash dividend; and even since the crash of 1929, our companies have paid out over $22,000,000 in cash dividends to shareholders.

As of today, I might say parenthetically, that is something over $35,000,000.

Again I quote:

Except in the case of one debenture issue, our trusts do not owe any money. They do not buy on margin or sell short. They do not buy or sell securities from or to each other. Except during the two offers of exchange and the brief period of the Nation-wide preferential bid, none of our trusts ever bought each other's shares. They are run as distinct from each other, except as to common management philosophy, as if they were in different offices, and it has never been our policy to deal as principals with our companies in security transactions. We do believe most earnestly that this business, as we run it, provides a genuine economic need, because we think a well managed investment company is the best medium for investment of any vehicle yet devised.

Senator HUGHES. Mr. Bullock, would you mind telling me, if you will, why you wanted more than one or why you had five? You said you had five, did you not?

Mr. BULLOCK. Yes, in 1932?

Senator HUGHES. Yes; and why you organized five?

Mr. BULLOCK. They were formed for different purposes. I think I would answer your question, Mr. Chairman, by asking why a man should not organize two trusts or five trusts instead of one trust?

Why would a man organize one trust instead of five—to put it the other way around?

I assume it would be for exactly the same reason that he would organize five.

Senator Hughes. I did not know whether there was any other reason than that.

Mr. Bullock. To make an honest living in a profession which has true economic justification and is of service—if such trusts are well run (and there is the essential point to investors).

That is all, thank you, Mr. Chairman.

Senator Hughes (presiding). I think we shall probably be able to return here at half past 2. Suppose we take a recess at this time, then, until half past 2. Then we shall hear from Mr. Traylor, this afternoon; is that the idea?

Mr. Griswold. Very well, Senator—Mr. Traylor.

Senator Hughes (presiding). All right; then we shall recess at this point until half past 2.

Mr. Bullock, we are very much obliged to you for coming here and giving us the benefit of your views. Thank you.

(Thereupon, at 12:45 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTERNOON SESSION

The committee reconvened at 2:30 p. m., upon the expiration of the recess.

Senator Wagner. Mr. Traylor, will you proceed, please?

FURTHER STATEMENT OF MAHLON E. TRAYLOR, PRESIDENT, MASSACHUSETTS DISTRIBUTORS, INC., BOSTON, MASS.

Mr. Traylor. Senator Wagner, members of the committee, before reading this I might say that this is one subject in which we have been very much interested, and in order to make the case complete, so that you will have it for the record, I should like to make this statement. It is a little technical, of necessity, and may be a little tedious in going through it, but I think it is absolutely necessary in order to cover all the points that explain the matter of dilution.

To again identify myself, my name is Mahlon E. Traylor. I am president of Massachusetts Distributors, Inc., underwriter or general distributor of shares of Massachusetts Investors Trust, Supervised Shares, Inc., and Boston Fund, Inc. These companies are open-end companies—that is, they have redeemable shares.

At this time, I would like to discuss the matter of pricing and selling shares of open-end companies. Judging by the S. E. C. testimony, this subject seems to afford the basis for the only noteworthy criticism of the open-end industry.

Senator Hughes. May I interrupt you just a minute?

Mr. Traylor. Yes, Senator.

Senator Hughes. How many companies have you?

Mr. Traylor. Beg pardon?

Senator Hughes. How many companies have you?

Mr. Traylor. We are distributor for three open-end companies.

And I should like to add, the implications of this testimony would appear on the surface to be very serious indeed. I believe, moreover, that there is a widespread misconception of what the problems really

are and how the pricing system actually works. I believe it most important, therefore, that any such misconception be corrected.

Now, this subject of pricing is a rather difficult one, both to explain and to understand, and I can only ask you gentlemen to bear with me as patiently as possible. Under the present bill, full discretionary powers to govern this phase of operations by rules and regulations are granted to the S. E. C. Mr. Schenker has said, because of various problems involved, it seemed desirable early in the consideration of this matter to vest such discretionary power in the S. E. C. rather than attempt to write an inflexible provision into the law. We were generally agreeable to this at the time, because we felt that the S. E. C. would adopt a practical attitude toward the matter and that between the industry and the S. E. C. a practical solution to the problems would be found.

Since then, however, the testimony of both Mr. Bane, of the Registration Division, and of Mr. Schenker leaves no doubt in our minds that they have already decided upon a method of pricing and selling shares which we believe to be wholly impractical.

Under these circumstances, or even if the S. E. C. has not definitely decided upon a plan, because of the manner in which their testimony on the subject has been presented, I am opposed to this grant of discretionary power. I believe, moreover, that I reflect the attitude of most of the industry in voicing this opposition.

Several days ago the S. E. C. presented testimony before this committee relating to the sale and repurchase of shares of open-end investment companies. Before you were paraded examples of so-called dilution, abuses, and malpractices. I wish to take exception to many of the implications of that testimony and to discuss the entire matter in some detail from the practical viewpoint of the industry.

At the very outset, I want to bring out one vital point. I want to make a clear distinction between so-called dilution, which may result from the mechanical operation of the pricing system, and the abuses of the pricing system which a small fringe element may have practiced unethically to further their own selfish ends. The former, as I hope to prove to you, is of negligible proportions. The latter represents unethical practice, pure and simple.

While these abuses have been relatively unimportant, though nonetheless deplorable, they could be eliminated entirely by the imposition of a few simple rules which most of the industry already observes in practice. I explain his because it is easy to confuse the word "dilute" with the word "loot," and I want to make it clear that the pricing system involves no element of the latter.

Now let me take up the mechanical aspects of the so-called dilution problem. The development of the pricing, selling, and repurchasing of shares has been an evolutionary one. The aim, of course, has been to establish a basis for doing business which would be equitable to both incoming shareholders and old shareholders alike; at the same time, it readily can be appreciated that such a basis must be practical in its operation. Needless to say, since the inception of open-end companies these matters have received the most careful consideration of those in the industry.

When the sale of open-end companies began in 1924, the prices at which new shares were offered for sale were revised only once every week or two, unless a sudden change in the level of the securities

markets made a prompter change seem desirable. In recent years, however, it has been customary to establish a new selling price each day on the basis of the liquidating value as established at the close of trading on the New York Stock Exchange.

To refresh your memories as to the mechanics involved, the so-called liquidating value or net asset value is determined (in our case by an independent custodian bank) by totaling the market value of all underlying securities, adding cash, deducting liabilities, and then dividing the resultant figure by the number of shares outstanding. To this per share liquidating value is added the underwriting commission, or so-called loading charge, which on the average is around 7½ percent. The selling price thus established generally remained in effect throughout the next full business day and until the opening of the stock exchange on the next succeeding day.

Shares sold on this basis, while netting the company liquidating value as last determined, obviously did not net the company the exact liquidating value at the time when purchase orders were taken.

Now, the S. E. C. testimony has set forth what, in the opinion of the Commission and its staff, constitutes dilution. You may recall the illustration of U. S. Steel advancing from 55 to 59 and that under the umbrella of that illustration was cited the example of the shares of an open-end company which on September 5 advanced in price from \$5.60 to \$6.70, and yet were sold to the public on the basis of a value of \$5.60, even though their established and known value was \$6.70, according to the S. E. C. testimony.

It is upon this illustration that the S. E. C.'s case in the matter of so-called dilution was very largely based. With all possible emphasis, I should like to say that this illustration is completely irrelevant as far as 90 percent or more of the open-end industry is concerned. It is also probably the most extravagant example the S. E. C. could have used. To employ Mr. Bunker's well-conceived analogy, this is most certainly a specimen, and an exceedingly rare one at that, rather than a run-of-the-mine sample.

You have heard that the S. E. C. figures so-called dilution as being the difference between the price at which shares are sold and the next higher price to become effective. This, however, does not accurately reflect the true situation. When an open-end company sells shares on Wednesday on the basis of the price determined at the close of the market on Tuesday, it is apparent that the selling price may not reflect the exact value of the shares at the time of sale. For example, (and for simplicity let us disregard the amount of the selling commission which plays a part in this discussion, but which I will bring up later), then assume that at the close of the market on Tuesday the value of the shares was determined to be \$20.00 and all day Wednesday these shares were sold at this price. But Wednesday the securities markets advanced so that by 11 o'clock in the morning, if we figured the value of the shares, or if we could have figured the value of the shares, we would find that they would be worth \$20.10. Yet the man who wants to buy them at 11 o'clock can do so on the basis of the \$20 price. Now, other things being equal, that might be called dilution because at the time the buyer enters his order the shares are worth 10 cents more than he has to pay.

Let us assume that 100 investors buy 100 shares each at 11 o'clock for \$20 a share when their indicated value is \$20.10. That makes

10,000 shares bought at 10 cents less than their indicated worth. Obviously there appears to be some dilution here. Ten thousand shares times 10 cents a share makes $1,000. This $1,000 is my tentative dilution figure in this illustration.

This requires a little patience—but now let us assume (and this is often the case in a rising market) that in the last hour or half hour of trading before 3 o'clock the market stages another advance, so that at the close the shares are worth $20.30.

Here is the nub of the thing. The S. E. C. contends that the company should receive on that day $20.30 for all shares sold during that day, despite the fact that this would prevent investors from buying during market hours, and in 9 times out of 10 on any substantial advance, the closing price, that is, what the investors would have to pay, would represent virtually the highest price of the day.

Then the S. E. C. arrives at its dilution figure by taking the difference between the last determined price ($20 a share) and the price at the close of the market ($20.30 a share), multiplies it by the number of shares sold (10,000 in this example) and arrives at a dilution figure of $3,000, as compared to my $1,000 figure. I claim that the figure of $3,000 is purely hypothetical, because, among other things which I will discuss later, it rests on the assumption that the company should and would receive $20.30 a share for the sale of 10,000 shares, when, as a matter of fact, it should not and would not.

In the first place, it should not because at best (or worst) the company should not be entitled to receive any more than the value of the shares at the time that an investor wants to buy them. Thus, as in my illustration above, if a man wants to buy some shares at 11 o'clock in the morning, when they are theoretically worth $20.10, the company should not be entitled to charge him any more than that. Yet the S. E. C. says (and its so-called dilution figures are based on the following assumption) that the company should not allow him to buy until after the close of the market and then at the price of $20.30. As explained previously, the S. E. C. then says that by selling shares at $20 instead of at the day's high price of $20.30, the interests of existing shareholders are diluted to this full extent of price difference.

In the second place, the company would not receive $20.30 (the high price based on closing market prices) for the simple reason that investors would not buy shares on that basis.

If that doesn't sound reasonable, I believe Senator Glass could explain why this is true by reason of his experience in the Treasury Department. You might ask him how many Government bonds he thinks the public would purchase if the Treasury Department were to tell prospective buyers that it would sell bonds only on the basis of a price to be determined in accordance with the exact level of interest rates prevailing at the close of trading in Government bonds for that day.

This is a practical consideration of great importance and I will discuss it more fully later. Suffice it to say at this point that a prospective investor, no less than a prospective buyer of any product, does not want to buy "a pig in a poke."

You might also ask Senator Herring how many automobiles he thinks he could sell if he told prospective buyers that he couldn't tell them what the price would be until after the close of business that day—when everyone had gone home, even including his salesmen.

Just to finish this illustration, let me say that I hold no brief for my theoretical dilution figure of $1,000 as compared to the S. E. C.'s $3,000 figure—it might be more or it might be less. Salesmen usually work from 9 in the morning to 5 at night and orders are taken all during that time on the basis of a known price at the time of sale.

My point is, that while that known price may be less than the value of the shares at the exact moment of sale, thereby causing some possible amount of the theoretical dilution, the amount of dilution is not even remotely related to the amount of dilution that the S. E. C. has had written into the record of the testimony before this hearing. Let us generously assume, however, for the sake of this discussion, that instead of $1,000 the dilution might $1,500—that's a half rather than a third of the S. E. C.'s $3,000 figure.

Now let us take a look at some so-called dilution figures, with a view to reducing the S. E. C.'s implications to their proper proportions. We have the S. E. C.'s example, which, incidentally, is based on the extraordinary occasion of September 5, 1939, following the outbreak of the war. On that day there occurred one of the sharpest market advances in history and the volume of sales of open-end company shares was unprecedentedly large. You may recall that much stress was given to the S. E. C.'s statement in testimony that the dilution of the interests of shareholders of open-end companies on September 5 amounted to $1,585,484. This, we all might agree, would on the surface appear to be a rather severe indictment of the method of pricing and selling shares. There is little doubt that the public too would so view the matter if all the facts were not made clear. Certainly $1,585,484 sounds like a lot of money to anyone.

But to have any real significance, that figure must be related to something. What should it be related to? The S. E. C. said this figure represented dilution of existing shareholders' interests as a result of selling additional shares for less than their value. This dollar amount of so-called dilution should, therefore, be related to the dollar value of existing shareholders' interests. This total dollar value—that is, of shareholders' interests—was approximately $500,000,000. Thus $500,000,000 of assets was, we will say, diluted by some one million, five hundred and eighty-five thousand. Expressed in percentage figures, this amounts to some three-tenths of 1 percent. In other words, taking the industry as a whole, the S. E. C. has really said that existing shareholders' interests were diluted to the extent of three-tenths of 1 percent on this abnormal, unprecedented occasion.

Of course, this $1,585,000 figure, or three-tenths of 1 percent, reflects solely the S. E. C.'s basis of figuring. On the compromise basis, as established in my illustration a while back, the corresponding figure would be only 15 one-hundredths of 1 percent.

Let me cite a specific instance, which, incidentally, I believe to be less a specimen and much more a sample than the S. E. C.'s examples. In the case of Massachusetts Investors Trust on that same abnormal occasion, and on the largest single day's volume of sales in its history, the S. E. C.'s dilution figures come to only 142 one-thousandths of 1 percent, and the compromise figure would be only 71 one-thousandths of 1 percent.

Leaving the war market situation and going back to the last bull market, for the full year 1936, on the largest volume of sales—over

$36,000,000—for any 1 year in the history of the business, so-called dilution in Massachusetts Investors Trust on the S. E. C. basis was only about one-fifth of 1 percent, and on the compromise basis only one-tenth of 1 percent.

I might also cite the experience of 1937, but that would show that a fairly substantial proportion of the funds received from the sale of new shares during that year was held in cash. Thus, whatever the infinitesimal dilution figure was, it was many, many times offset by the advantage to existing shareholders which resulted from the cash holdings of the trust being increased by the sale of new shares during a year in which the securities markets registered a rather sharp decline.

So far I have confined my remarks largely to the abnormal and unprecedented occasion of the war market of September 5, 1939. The S. E. C. testimony states, "Now, granted, which we do, that September 5 was an unusual day, no one can contend that the market fluctuations on September 11 and September 19 were in any way abnormal." Then, the testimony states that the dilution on these 2 days was $72,000 and $104,000, respectively, making a total of $176,000.

Now, by the S. E. C.'s own testimony, this so-called dilution figure comes closer to representing the problem such as it is under normal circumstances. I say "comes closer," but I might add that it is still far from representing the true situation. As proof, let me point out that during the entire year 1939 and so far in 1940 there was only 1 day (excluding September 5) when the market advanced as much as it did on either September 11 or 19, the 2 days which the S. E. C. has chosen to represent as being in no way abnormal. Be that as it may, if the S. E. C. says this is the normal situation, then let us see what their dilution figures look like under the so-called "normal" conditions. According to the S. E. C. testimony, total dilution on these 2 days was $176,000 for the industry.

Now this is most illuminating: In relation to the value of shareholders' interests—some $500,000,000—the so-called dilution figure of $176,000 for the 2 days picked by the S. E. C. amounts to 00.035 percent, or about 35 one-thousandths of 1 percent. On an annual basis, this would come to about 5 one-hundredths of 1 percent; and if we double it to take care of a few semiabnormal days, it is only one-tenth of 1 percent; and if we triple it to take care of a few more, it is still only 15 one-hundredths of 1 percent.

That, gentlemen, by the direct process of employing the S. E. C.'s language and figures on a basis which has a significant meaning, is the so-called dilution problem in a nutshell.

In this connection, I would like to call attention to an editorial comment which appeared in the April 8, 1940, edition of the Christian Science Monitor, a paper which I think we may all agree has a well-deserved reputation for its impartial and intelligent reporting of the news. I quote in part:

> Nor is the Commission seen likely to get far with such testimony as that about the microscopic watering of the shares of open-end trusts by the sale of shares somewhat below closing prices during rising markets. * * * you can't help that very much. That's what the Treasury generally does when it sells a new bond issue and it promptly goes to a premium. It's an odd charge and seems to mean the open-end people are wrong anyway, for if they sold at the day's price and then it went down, that wouldn't be so good either.

I have explained the mechanics of the pricing system and have shown that the so-called dilution, even on the S. E. C.'s basis of

figuring, is negligible when, as is fitting and proper, it is related to the dollar amount of shareholders' interests involved. But there are other and equally important considerations which require explanation in connection with this matter.

At the hearings the other day, one of the Senators asked Mr. Bane, the S. E. C. witness, What happened to all that one and a half million dollars or so of so-called dilution in September 1939? Was it lost? Mr. Bane replied that it was lost to the trusts. On further questioning, however, he stated that he did not mean that any particular individual got away with all that money, but he failed to point out that it was the incoming shareholder who got whatever advantage there was to be had. It was not, however, a loss to the companies as the S. E. C. theoretically contends, for the following practical and concrete reasons:

Reason No. 1: The value of the shares as established at the close of the market is at best something of a theoretical value in that it merely represents what the shares were worth as closely as could be figured at the precise moment at which trading on the exchange ceased for that day. Now, as we know, the market fluctuates from one day to the next and many days it opens lower than it closed the previous day. Is it not rather theoretical and inaccurate, then, to figure dilution as the difference between the closing price one day and the closing price of the next, when the opening price of the following day may be less than the previous closing price, as it often is? In other words, how can a definite fixed amount of dilution be established merely by figuring the difference between two prices, neither of which represents definite fixed values?

Reason No. 2: The money received from the sale of new shares is not necessarily invested at the exact level of security prices on which the S. E. C. has figured its so-called dilution. For example, the stock market as measured by the Dow-Jones industrial average stood at around 150 on September 5, 1939, when a lot of money was paid into open-end companies. And a lot more money was paid in later on in that month at higher stock-price levels—about half our sales volume for the month came in after September 5.

Now, since that time the stock market as measured by this index has fluctuated between a high of 155 and a low of 143. In fact, during most of the time in the last several months it has been in the 140's and managements have had ample opportunity advantageously to invest cash which was taken in at higher levels.

I have already touched upon the situation in 1937, and any study of the pattern of stock-price movements will reveal the fact that these opportunities to invest new money at favorable levels do not represent isolated examples. This, of course, is a matter for management judgment, but when a management is satisfied that the accumulation of some cash is advisable, then the proceeds from the sale of shares is a source which may provide such cash without incurring the expense of selling portfolio holdings. On other occasions the management may want immediately to invest new money, and I will describe how that works in relation to so-called dilution in my next point. But the essence of the situation I have just described is that the S. E. C.'s theoretical conclusions with respect to dilution are further invalidated by these concrete practical facts.

Reason No. 3: As a practical matter of operating policy, most investment trusts, open-end and otherwise, usually keep from 3 to

10 percent of assets in the form of cash. The average is perhaps 5 to 6 percent. Under what I might call the normal conditions which exist most of the time, this cash constitutes a sort of a liquid reservoir to facilitate operations, to meet expenses, and to serve in the occasional emergencies. I might interpose here to state that cash received from the sale of new shares on any one day very rarely ever exceeds 5 percent of a company's assets. Now, let us assume that a company having total assets of $10,000,000 has 5 percent or $500,000 in cash. The news of the particular day in this illustration is rather favorable and the management rather expects that a rising market might develop. With this thought in mind, and knowing from past experience that such a development would stimulate investor interest and that the company would doubtless sell some additional shares, the management naturally makes its plans accordingly.

What does it do? When the market opens in the morning, it begins buying some stocks at prices which reflect fairly closely the price level at which its own shares may be bought by the public. In other words, the management draws down from its reservoir of cash to buy securities, knowing that the reservoir will be refilled with cash from the sale of new shares.

Assume that the company described above anticipates, from past experience, sales of around two or three hundred thousand dollars. That is an extreme example, but let us leave it extreme to remove any question about my point. This company would thus invest, say, $250,000 of its cash during the day at the same time that investors would be paying new cash into the company for the purchase of new shares. I might explain that while actual cash might not be coming in, execution of orders amounts to the same thing from a bookkeeping standpoint, because they carry it the same way. What happens then is simply that new cash from investors is substituted for old cash on hand. The result is that by simple common-sense management policy designed to meet the practical business problem which arises from the receipt of new cash, the theoretical dilution factor which the S. E. C. has called a loss may be reduced to such negligible proportions that it cannot be measured. And this is no isolated example but a matter of everyday routine in the management of open-end companies.

This leads into another point. The S. E. C. witness discussed at length what he considered to be the evils of the so-called two-price system—that is, the old pricing system by which two prices were known to investment dealers at the same time. The two prices were (1) the price at which investors could buy, and (2) the price which would next become effective.

First, I want to say that in past years, the existence of two known prices was only an unimportant incidental in the actual selling of shares of open-end companies. Secondly, consistent with the past record of the industry with respect to improving its practices in the light of experience, steps were promptly taken to further refine the pricing system when the unprecedented experience of September 5, 1939, indicated the desirability of such action. The result is that at the present time there are relatively few companies having two established prices at the same time.

Despite these facts, the S. E. C. witness stated that the two-price system "enables it to be used as, and it is used as, one of the principal selling arguments by many of the open-end investment trusts." Now, I don't know how much "many" is, but the implication which I

read in this statement, and the several other references to the same point in the testimony, is that it is a principal selling argument, employed pretty generally throughout the industry. I must take exception to any such implication, because the facts of the case as I know them from wide experience do not support it. If all we had to do to sell our shares was to impress on people that they could buy at a price based on an asset value which was a few cents under the theoretical value at the time, I assure you, gentlemen, that our job would be an easy one.

But what are some of our principal selling arguments? I would say that the backbone of all our selling arguments is the basic theory of operation of some 90 percent or more of the open-end companies. This theory is that when many individuals combine their capital in one fund under capable and experienced management, each one obtains the following important benefits: (1) Broad diversification of investment risk; (2) careful selection and continuous supervision of investments by individuals qualified to do this work; (3) greater assurance of continuous income; (4) low cost of administration, made possible because many investors share expenses. And, as an important safeguard, there is the fact that the investor can withdraw his proportionate interest if he becomes dissatisfied, or for any other reason.

That is the fundamental basis of our selling arguments—and it is a sound basis—and in its operation it produces worthwhile results. But I will tell you right now that it is more difficult to sell the average investor, and particularly one of moderate means, on a sound idea than it is to sell him on an unsound one. And I assure you that the process of selling him a sound idea cannot be undertaken successfully with no more logic and reason than is embodied in a few cents price advantage.

Incidentally, and I do not think the S. E. C. made this point clear enough in its testimony, the fact that an investor has to pay an underwriting commission or so-called loading charge virtually eliminates even the opportunity in our type of company to buy at one known price and immediately resell at the next higher known price. That is, in buying, the investor pays the asked price, which includes the loading charge of around 7½ percent on the average, and in selling he receives the bid price, which is the asset value of the shares. For example, even on the abnormal and unprecedented occasion of September 5, 1939, the price at which investors could buy shares of Massachusetts Investors Trust was above what they could sell them for the next day. Moreover, and this refutes the implications of the S. E. C. testimony with respect to many important companies, the incoming shareholder did not even know what the new bid price would be until after he had placed his order, because these companies stopped selling shares before the new bid became available.

My next topic has to do with what I consider to be the essential need for a firm price at which shares can be offered to the public. This matter ties in very closely with the foregoing discussion of the pricing system, as it will show what part the selling price actually does play in the distribution of shares to the public by investment dealers throughout the country.

I might mention at the outset that certain individuals in the industry do not fully concur with my views on this subject. I believe, however, that my views, which are based on a great many years of

practical experience in the securities business, are fairly representative of a large majority of opinion. And if opinion were weighted according to the volume of business done, I think that any dissenting opinion would be of small relative importance.

As I mentioned earlier in this statement, the S. E. C. testimony convinces many of us that they have already decided upon a theory of pricing and selling shares which, we are convinced, would seriously cripple the whole industry. This theory contemplates that shares be sold only on the basis of a price to be determined as at the close of the stock exchange on the day on which purchase orders are executed. Adoption of this theory of selling shares would, in my opinion, be unsound, impractical, and unfair.

I referred a short time ago to the automobile business and how impractical it would be to do business if you had to tell a customer that you would be glad to sell him a car, but you couldn't tell him the price until the close of business that day, after everyone had gone home. Now, let me explain in a little more detail how this principle operates in the securities business. I have said that the S. E. C.'s theory of selling shares is unsound, impractical, and unfair. It is unsound because it would unduly penalize the incoming shareholder by making it impossible for him to buy shares during market hours. In many instances it would force the incoming shareholder to pay a higher price than their value at the time he wished to place his order, and in most of such instances that price would be virtually the highest of the day.

It would be impractical and unfair because it would not permit of a firm price at which shares may be offered by investment dealers during the business day. Such a firm price is essential to the successful distribution of securities on an investment basis. The need for a firm price is not peculiar to the open-end trust business. Virtually all new syndicate issues are sold at a stated price which is maintained until the syndicate is closed, regardless of general market conditions. A firm price is maintained in the case of bond offerings, even when similar bonds of the same issuer are already outstanding and are being traded actively at varying prices.

The United States Government has long recognized the practical necessity for a firm price in offering securities. The Treasury regularly sells United States Treasury bonds and notes on a firm basis, and it is long-established and accepted practice for the Treasury to price a new issue in relation to its outstanding obligations so that the new issue will immediately sell at a premium. So-called baby bonds are offered year in and year out at one fixed price so as to simplify distribution of a sound investment security to thousands of small investors. We maintain that it is as impractical to assume that the Treasury should sell bonds only at a price to be determined on the basis of interest rates prevailing precisely at the exact moment when trading in Government securities stops at the end of the day, as it is to assume that open-end investment companies should sell shares only at a price to be determined at the precise moment at which trading ceases for the day on the New York Stock Exchange.

In the case of open-end funds, there is no conscious effort to "price the shares favorably in relation to the general market." In fact, the only thing that is desired in connection with the pricing of shares of

open-end companies is to establish a firm price as closely in line with the actual value as is practically possible.

We do not contend that open-end companies should have any advantage over any other type of issuer by distributing shares on a basis contrary to that generally followed in distributing other types of conservative investment securities. We maintain merely that we should not be, and that there is no necessity for our being forced to operate on a basis so different from that followed in other lines of the investment business and so impractical that we would be unable to place shares in the hands of individual investors who, we are convinced, would benefit from the service which open-end investment companies render.

The S. E. C. testimony reflects a highly critical attitude toward this entire matter of the pricing of shares of open-end companies. I wonder, however, if in considering this matter in broad perspective they have ever stopped to think just how the open-end pricing system has worked out over a period of time as compared to any other practical pricing system that might be devised.

The redeemable share feature of the open-end industry—and it is around this feature the pricing system has developed—has the great advantage that a shareholder can have his shares redeemed by the company at a price reflecting the full value of his proportionate interest at any time.

Now to preserve such a desirable feature on a practical basis may well involve some small expense, and as I believe I have shown you, it is an extremely small expense. If we assume, therefore, that the fractional percentage amounts of so-called "dilution" constitute the cost, in a practical sense, of preserving the desirable redemption feature of open-end companies, then perhaps the situation may reveal itself in a somewhat better light than I believe it has been presented to this committee by the S. E. C.

One further thought on this subject before leaving it. When I say a firm offering price is essential, I mean it with all emphasis. And if the industry were required to operate without a firm price, I doubt if it could live for long. But in endeavoring to live, one of the first things that would be necessary, in my judgment, would be to increase the selling commission. This is natural. Lack of a firm price would make the sale of these shares more difficult for reasons I have explained. And if selling them becomes more difficult, salesmen will have to be paid more for the effort.

As a result, I can envisage underwriting commissions being increased. Which is better—a healthy industry operating on a basis which insures preservation of the very desirable redemption feature at a cost of infinitesimal proportions, or a faltering industry that can only operate by increasing its charges for new business and possibly with increased costs of company operation in addition?

I now want to discuss very briefly the so-called abuses of the pricing system. I will not go into detail, because such abuses as have occurred are of little relative importance. This does not mean that the opportunity for the practice of any abuse should not be eliminated. This, however, could be done very simply and effectively. I must take emphatic exception to the implications of the S. E. C. testimony on the subject to abuses on much the same basis as I have taken exception to the testimony regarding so-called "dilution," although I shall not go

into the details. Suffice it to say that in my judgment the implications of much of the S. E. C. testimony certainly tend to create an extravagant impression of the seriousness of the situation. This is not justified by the facts as I know them by wide experience.

I do, however, recognize that there have been opportunities for abuse and that abuses have been practiced. Isolated as the cases have been, however, and unimportant as they were in relative significance, I naturally deplore the possibility of their existence. In my own business, as opportunities for abuse came to light or were anticipated—and it was only by experience that sound progress could be made in this direction—we adopted various measures designed to prevent them. I can report that in so doing, we have encountered no serious difficulties and we believe that we have effectively accomplished our end.

To insure uniform observance of proper standards of practice for the entire industry, I believe it would be desirable to incorporate in specific law or in some code of fair practice—observance of which would be mandatory in the open-end industry under some such instrumentality as the National Association of Security Dealers formed under the Maloney Act—certain specific rules and regulations.

Steps have already been taken in recent months to formulate such a code. A committee has been formally appointed by the National Association of Securities Dealers to consider the matter and act upon it as soon as possible. In this connection I would like, if it is permissible, to place in the record an editorial on the subject of self-regulation under the Maloney Act which appeared in the April 8 issue of the Wall Street Journal.

Senator WAGNER (chairman of the subcommittee). That may be done.

Mr. TRAYLOR. The editorial is as follows [reading]:

[Wall Street Journal editorial, April 8, 1940, issue]

TRUST SHARES DISTRIBUTION

Because the distribution of the shares of open-end investment trusts is specialized and the problems often dissimilar to those in other investment fields, it is a logical step for the National Association of Securities Dealers to appoint a separate committee, as it has done, to study the underwriting and distributing of such shares in connection with rules for self-regulation of that business. As the association points out, the distribution of such shares is a dealer business and it is possible to formulate rules and regulations governing it and enforce them also through the National Association of Security Dealers.

Also quite in order is the indication that this new investment trust underwriters' committee will hold several open meetings at which all underwriters will be represented before the rules are drafted.

While a program worked out for such companies under National Association of Security Dealers supervision would not necessarily conflict with or overlap the new regulatory law proposed by the Security and Exchange Commission and now before Congress, it would seem that the National Association of Security Dealers program should get the right-of-way; that is, that Congress withhold any legislation of further investment company supervision until the National Association of Security Dealers gets a chance to develop its own plan for that business.

For the National Association of Security Dealers was organized for self-regulation and this would seem the logical time to give it a chance to function.

It seems to me that the problems which seem to exist in connection with the pricing and selling of shares may best be solved by people in the industry who have had practical experience in meeting them. A solution arrived at on this basis could be most helpful to the conduct

of the business in accordance with sound and practical principles. At the same time, such a solution would avoid the risk that the entire industry might be seriously crippled. Such a risk I believe is inherent in the delegation of discretionary power to regulate this phase of operations as granted in this bill.

Senator WAGNER. Mr. Traylor, you mentioned that your particular concern and some others have taken steps by the adoption of procedure to prevent abuses which in the light of your experience you think maybe cured. I want to ask you this. How is the price for the following day fixed? Are there some of your experts who calculate the value?

Mr. TRAYLOR. It is done by the custodian bank, Senator, every afternoon.

Senator WAGNER. I suppose it is true that if one wanted to take advantage of the situation it might be done. For instance, if he knew at the end of the day or near the end of the day that the price on the following day would be higher, say, a dollar or two, I should think it would be an abuse if, taking advantage of that, a large block of shares were bought at the end of the day.

Mr. TRAYLOR. There are two angles to that, Senator. In the first place, one of the abuses that occurred was where an insider, so called, a director or trustee, in a few instances did not have to pay the asked price.

Senator WAGNER. That is what I had in mind.

Mr. TRAYLOR. And then turned the shares back the next day. I think there were a few instances of that. Under the blue-sky law of Ohio there is one provision which makes it necessary for insiders to pay the full asked price, the members of the distributing organization and all the trustees and officers of the trust itself. In Ohio, I might add, 80 percent of the assets represented in the whole open-end industry are qualified for sale in that State. So that that particular abuse is literally cured now, at least in so far as the companies that operate in Ohio are concerned.

Senator WAGNER. That is just 1 State. We have 48 States.

Mr. TRAYLOR. Yes; but those regulations were adopted by the National Association of Security Commissioners at Skytop, Pa.; and several other States have already gone so far as to adopt those regulations. If you are observing the regulations in Ohio you are observing them all over the country, wherever you may operate. You cannot sell in Ohio under one regulation and sell in another State under another regulation.

Senator WAGNER. Why?

Mr. TRAYLOR. If we agree that we are not going to distribute our shares except on the basis that is necessary in Ohio, that means that we have agreed to that wherever we may sell them.

Senator WAGNER. That may be true of your company.

Mr. TRAYLOR. It is true of all.

Senator WAGNER. Suppose there is a company that is not going to do any buying or selling in the State of Ohio?

Mr. TRAYLOR. There may be some that are not qualified in Ohio; that is true. But 80 percent of the industry is represented at the present time and is qualified to do business in Ohio.

I might say, further, that I use Ohio as an example. But this matter of inside trading the industry wants to cure. It should not have existed; it should not be allowed to exist, and it has been cured

insofar as 80 percent of the industry is concerned, by this Ohio regulation, which is a step in the right direction.

Senator WAGNER. We had some testimony here, as you recall, where that practice was followed in some instances by insiders, which I know the industry as a general thing would condemn, and which you condemn. If it is an abuse it ought to be prohibited. So long as the legislation is carefully drafted, why should it not be prohibited?

Mr. TRAYLOR. It should be prohibited. The suggestion which I gave in my testimony should be that under the N. A. S. D. rules and regulations be devised by the industry itself, which would be adopted by all of the members of the N. A. S. D.

I might further add that all of the underwriters of open-end industrial companies are members of the N. A. S. D., and cannot sell to any other dealer who is not a member. A dealer cannot sell his shares at a discount. So in this particular case, if they did establish those rules and regulations, we would be doing business only with people who had agreed to operate under those rules and regulations.

Senator WAGNER. Is the act now working all right?

Mr. TRAYLOR. The Maloney Act?

Senator WAGNER. Yes.

Mr. TRAYLOR. So far as I know. We are all operating under it. I think this also could be covered under that act.

Senator WAGNER. The reason I asked the question was because there was considerable opposition at the time.

Mr. TRAYLOR. I can only speak insofar as our business is concerned. There has been no great hardship as the result of it.

Senator WAGNER. Are there any further questions?

Senator HUGHES. You have an organization, you say? You are already organized?

Mr. TRAYLOR. Yes, sir.

Senator HUGHES. What proportion of the industry?

Mr. TRAYLOR. What part of the industry?

Senator HUGHES. Yes; all over the country.

Mr. TRAYLOR. In its pricing system I would say that a majority have already changed their pricing system to some extent since September 5, and I think it is the attitude of the rest of them who have not made changes that the only reason they have delayed making them is because of the legislation now before us at this time.

Senator WAGNER. Is not that a good time to remove an abuse, when legislation is pending? The removal of abuses is one of its objects. Is not this a good time to do it?

Mr. TRAYLOR. Well, it is more difficult than that, Senator, because, in order to change the pricing system in many of these companies it would require stockholders' meetings to vote for those changes. They did not want to have a meeting and change the charter to cover pricing, and then have to change the charter to cover this law, for instance. That is expensive; it is very costly. I think the delay by a number of companies has been due to that.

Senator HUGHES. Would they have to change their charters to cover prices?

Mr. TRAYLOR. Yes; because it is very definitely defined what they can do and what they cannot do, in their charters.

Senator HUGHES. I did not realize that. I thought they had broad powers; I did not know they had specific regulations of that kind.

Senator WAGNER. Thank you very much, Mr. Traylor.

STATEMENT OF DAVID T. SANDERS, RESIDENT MANAGER AND WHOLESALE REPRESENTATIVE IN CHICAGO OF MASSACHUSETTS DISTRIBUTORS, INC.

Senator WAGNER (chairman of the subcommittee). Mr. Sanders, you represent Massachusetts Distributors, Inc.?

Mr. SANDERS. Yes, sir.

Senator WAGNER. Will you give us your official connection?

Mr. SANDERS. Mr. Chairman and Senators, to identify myself, my name is David T. Sanders. I am the resident manager and wholesale representative in Chicago of Massachusetts Distributors, Inc. During the last 8 years, all of my time has been devoted to the sale of open-end investment companies through registered investment dealers, in 17 States located in the Middle West and the Southwest. In order that no one may wonder how I can live in the Middle West and talk like a Yankee, let me explain that I was born and raised in the northern part of the State of Maine.

I would like to impress upon this committee that my job is selling. I make my living selling and it is my only means of support. I am thoroughly familiar with what goes on in the territory which I supervise and which I personally cover. In passing, let me add that approximately 75 percent of my time is spent on the road. It has been for the past 8 years. Any remarks that I have to make today will be confined to my own personal experiences and observations. Therefore, if some of my remarks, as I go along, seem to be limited to one section of the country and to one group of dealers, you will, I hope, understand my reasons for so doing.

In studying the testimony which has been presented in this hearing by the various representatives of the Securities and Exchange Commission, I have been impressed by statements which, in the light of my own personal experience, seem to me to be entirely contradictory to the true facts.

First, in reading this testimony, I was impressed with the fact that the impression must be left in the minds of anyone either reading or hearing this testimony, that the sale of open-end trusts has been accomplished through and by the use of inexperienced and high-pressure sales organizations. Furthermore, in this same connection, I am sure that anyone reading this testimony would certainly not be able to distinguish in his own mind any differences between the open-end funds, partial payment plans, and face amount certificates, which types are being sold continuously.

Senator HUGHES. You say there is no difference?

Mr. SANDERS. There is a big difference, but I do not think from the testimony that anyone would be able to determine that there was any difference.

Senator HUGHES. Oh. I see.

Mr. SANDERS. I want to make the point that there is a difference in the way they are sold.

Senator WAGNER. Do you send out literature?

Mr. SANDERS. Yes, sir.

Senator WAGNER. Have you a sample of the literature with you at this time?

Mr. SANDERS. No, sir; I have not. We have many pieces of literature, of course. I will be very glad to submit some literature. I have some at the hotel.

Senator WAGNER. May we have it tomorrow?

Mr. SANDERS. Yes, sir. I now come to my second point. Let me explain that I am objecting to three things here which I have found in reading this testimony which are contradictory of what my experience has been. The second point is that the buyers of these shares have been unsophisticated and inexperienced investors. The implication has been made here that open-end trust shares have been largely sold to parlor maids, cooks, truck drivers, waitresses, and so forth.

Thirdly, that the so-called two pricing system has been the principal sales argument used in the sale of these open-end companies.

It is these three points that I would like to discuss in the light of my own personal experience as a salesman and I will take them up in the order in which I have enumerated them.

First, the type of sales organization that has distributed these shares.

During the last 8 years, in which I have been in this business, I have come to know on a personal basis the senior officers, sales managers, and salesmen of approximately 250 investment firms, which is about the number that I am doing business with at the present time. Of course, you must realize that a man traveling a territory as large as this for so many years knows many more than 250 dealers. However, I am talking only about those that I know intimately and with whom I am doing business.

These dealers to whom I refer are, for the most part, old and established firms who enjoy the confidence of their customers and have an unquestioned reputation for integrity in the cities and in the towns in which they are doing business.

These dealers, with a very few exceptions, are the same dealers who distribute the bond and stock issues which are originated by the large underwriting houses in the East, Middle West, and the Pacific coast. In fact, a great many of these dealers are more often than not included in the banking groups on these underwritings. Furthermore, I think it might be interesting to note that they are the same dealers who in years past did the underwriting for most of the small industrial and public utility companies needing capital in the sections of the country in which they operate and live.

The distribution of the open-end funds which I represent has not been accomplished through "fly-by-night" high-pressure, inexperienced sales organizations, but through the type of dealer whom I have described, and it has been through and with the cooperation of this dealer group—and here I would like to add that every single dealer has signed our selling group agreement; we have no dealers who have not signed our selling group agreement—that more than $75,000,000 of Massachusetts Investors Trust, Supervised Shares, Inc., and Boston Fund, Inc., has been sold to the investing public in these Middle Western and Southwestern States.

Although it is impossible for me to give you an accurate figure as to just how long these dealers, as a whole, have been in business, I am sure that I can make the statement without contradiction that at least 75 percent of them have been in business more than 10 years and a great many more than 20 years and some of them even as long as 35 or 40 years. In the limited time which I have had to prepare myself before appearing before this hearing, I was not able to make a complete and accurate analysis of all the dealers in my territory. But I was able to make a study of the dealers in the city of Chicago with whom I now do business. This dealer group,

I believe, is fairly representative of the whole territory. This study brought out the following facts. At the present time, we have 41 dealers in Chicago. This includes a few branch offices of eastern dealers. I found that 29 of these dealers are members of the Investment Bankers Association of America; that 10 of them are members of the New York Stock Exchange, and that they have been in business in the average for 22 years.

In this connection I would like to add that every one of our dealers anywhere in the United States is today and must be a member of the National Association of Security Dealers. I think that applies to 95 percent, at least, of all sponsors of the business today. I do not know that it is not a hundred percent, but I would not dare to make that statement. I am sure that practically every dealer selling investment trusts today, the open-end trusts, is a member of this association

I hope the above facts will convince you that the sale of open-end funds has been made through reputable dealer organizations.

Now I would like to take up my second point, namely, that the buyers of these open-end funds have not been unsophisticated, inexperienced investors, but, on the average, quite the contrary.

To bring out this point in a clear-cut manner, I would like to submit the following figures taken from the 1939 annual statements of the three oldest and largest open-end funds in Boston, namely, State Street Investment Corporation, Incorporated Investors, and Massachusetts Investors Trust. I would like to call to your attention that the youngest of these three funds has been in operation more than 14 years.

The combined assets of these three funds, as of December 30, 1939, amounted to approximately $210,000,000, and the shares of these three funds were, on that date, held by approximately 88,000 stockholders. From these two figures, we are able to determine the average holding in these three funds, which is approximately $2,400.

I am simply trying to make the point here that these funds have not been sold to $10 buyers, but there is an average here of $2,400; and I think that represents a rather substantial investment, when you consider that that is only part of what most of these investors buy.

Senator WAGNER. Do you not think it would be a good thing if we could have investment trusts in which men with $10, $15, $25 or $100 could invest?

Mr. SANDERS. I think it would.

Senator WAGNER. I mean, it would be well if such opportunity existed. I really think that investment trusts play a very important part in our economic life; and I should think that those recognized investment trusts, those which are operated legitimately, would, as many of them have said, invite regulation, so that whatever confidence some of these disclosures have weakened would be restored. That is one way of restoring such confidence. I am a great believer in investment trusts, myself. I think there is a marvelous opportunity for one who wants to diversify his investments. I think they will in the future play an even greater part in our economic life, because it is difficult now for one to know just what to invest in. I should think some regulation would restore the confidence which has been weakened because of some of these exposures which have

shocked this committee, as they would shock you, I am sure, if you heard the testimony.

Senator HUGHES. Right along that same line: Have you a minimum restriction?

Mr. SANDERS. Five shares except to an old stockholder. He can buy one.

Senator WAGNER. Which is how much?

Mr. SANDERS. At the present time it would be about $110.

I would like to answer your question, Mr. Chairman, about the $5 or $10 buyer. I do not know what the answer is. No one yet, that I know of, has found how to sell the $10, $15, or $20 buyer at any reasonable cost. The cost is terrific, to reach that type of buyer. The salesman has to eat.

Senator WAGNER. Yes; I can see that difficulty.

Mr. SANDERS. And you can see how many $10 sales he has got to make.

Senator WAGNER. It may be that he would not have to be solicited, though of course I do not know as much about it as you do. You may proceed.

Mr. SANDERS. Please let me explain that in offering these figures—I am referring to the figures which I previously gave—I chose these three funds not only because they were the oldest, but also because they represented, in their combined assets, approximately 40 percent of the estimated total assets of all open-end investment trusts. It is quite possible, and probably true, that the average holding for the entire open-end trust industry would not be as large as the average holding in the three trusts which I have mentioned.

In connection with this same subject in regard to the type of buyer, I would like to give you some of my personal experiences with institutions which today own substantial blocks of Massachusetts Investors Trust and other open-end funds.

Because of the nature of our business, it is impossible for us to disclose the names of stockholders. Therefore, in citing these examples, the names are omitted.

The first example concerns a large educational institution. This institution has an enviable record for satisfactory results in the investment of its endowment funds.

This institution employs two experienced financial advisers to analyze securities and make their suggestions to the board of trustees for approval. It is my understanding that nothing is ever bought or sold without the approval of this board.

In 1935, after several months of careful study, in which these two advisers carefully analyzed one of our funds—and I might say they went through it with a fine-tooth comb—they submitted their recommendation to the board of trustees, which resulted in the investment of approximately $250,000 in this fund. During the subsequent years between 1935 and 1939, no further investments, to my knowledge, were made by this institution in open-end investment trusts. It is my firm conviction that they were watching this trust which they had purchased, in an effort to gain experience from this investment. However, this is only my assumption. I do know, however, that during the year 1939, this institution invested an additional $1,000,000 in open-end investment trusts. I don't know what conclusions you will draw from this, and I don't know that I have any right to draw

a conclusion but I am going to make this statement, that after nearly 5 years of holding and living with a $250,000-investment in one open-end company, these people must have been at least fairly well satisfied with their investment or they would not have put $1,000,000 more into 9 or 10 open-end trusts and included in this investment a fund sponsored by the same people who had sponsored their original investment.

My second example I will make very brief. It has to do with the purchase of approximately $1,500,000 of open-end trusts by one of the best known medical foundations in this country. I won't go into a long, detailed account of these purchases. I simply want to make this statement—that these investments, to the best of my knowledge, were made over a period of 6 or 7 years; that today they represent approximately $1,600,000, and that they are spread over four different open-end funds.

I would like to cite one more example, as follows: This institution is one of the best known fire insurance companies in the Middle West, has been in business more than 70 years and for the first 66 years of its existence, I am told by the present officials of the company, had never purchased any common stocks of any kind. In 1934, they made their first investments in this field in the form of four open-end-investment trusts and one closed-investment trust. It is my understanding that from time to time they have increased their investment in this field and that, with the exception of one open-end fund, they have in every case divided their investment equally between the four remaining funds.

I could go on for hours giving you one example after another of large purchases that have been made by trust accounts, schools, colleges, hospitals, churches, fire insurance companies, fraternal organizations, cemetery foundations, and a few life insurance companies, but that would be rather tedious.

If you will allow me, however, I would like to finish up this second part of my talk with this statement—that at the present time, Massachusetts Investors Trust has among its stockholders more than 900 trust funds and more than 1,000 institutions of the character described above.

I now come to the third and final point which I would like to make. It is this—contrary to the statements which have been made in this hearing by the Securities and Exchange Commission, it is my firm conviction, and this is based on actual personal experience in the field, that the pricing system which has been so much discussed has very little, if anything, to do with the real reasons why investors buy these open-end trusts. Let me explain.

In our business, we often have dull periods lasting weeks, and sometimes months. It is during these dull periods that a great deal of educational work is done by investment dealers. This is the time when their salesmen are making new contacts and renewing old contacts. It is a time when the buying public is uncertain and, even though they have money to invest, they are in a waiting mood. This is human nature. We do not create it, neither can we change it.

These dull periods are inevitably followed by more active periods when investors as a class seem to have made up their minds what they want to do and, as a result, our market place immediately becomes active and sometimes hectic.

It is natural that during these active market periods, new bond issues, new stock issues, open-end investment-trust shares, and securities of all classes are sold in greater volume.

It is perfectly ridiculous for any one to assume that the salesmen in our business sit around for weeks waiting for an active market, and that when it arrives all they have to do is get on the telephone, call up a lot of people and sell them millions of dollars of trust shares on such a flimsy basis as a rising market or some tricky pricing system.

I can assure you, gentlemen, that investment trusts are not sold that way. If you will be patient with me, I should like actually to demonstrate in this room exactly how most of these sales are made.

Without being presumptuous, may I assume for the moment, Mr. Senator, that you are a security buyer and that I am a retail salesman, representing a reputable investment dealer, and that you are my customer. For a number of years, we have done business together. You have purchased from my security house, through me, municipal bonds, corporate bonds, preferred stocks, and common stocks. A great many times during our conversations I have mentioned to you a certain open-end company. I have supplied you with a prospectus and probably with an annual report as well as several quarterly reports, and it is more than possible that occasionally I have mailed to you other descriptive material. These discussions may have gone on for months, as they often do. In fact, I have known them to ex-extend over a period of 2 and 3 years. You have told me that you have money to invest and that you believe part of it should be invested in a diversified list of equities; but you have hesitated to commit yourself, due to any number of uncertainties which may be worrying you.

To be more definite, let me further assume that I might have discussed with you a certain open-end company in November or December of last year and, in subsequent months, supplied you with many pieces of literature and answered the many questions that you naturally would want to ask. It is quite possible, due to political and general business uncertainties which have prevailed in the last few months, that you would have been uncertain and indecisive, and so would have desired to wait; but you have pretty well made up your mind and have given me to understand that when you felt the time was right, you would like to make an investment in this trust. Finally, something changed your mind. You are no longer doubtful, and you are ready to invest. It makes no difference why you changed your mind—it might have been the U. S. Steel $1 dividend or a change in the war situation, or any number of things. The fact remains that you think it is time to buy, and the stock market is stronger.

You might have telephoned me, or I might either have telephoned you or called on you at your office. Naturally, I would tell you what was going on in the stock market. You would naturally ask me the price of the shares, and I would give it to you. The sale would be closed right there.

There are two points here that I want to make. One is that you, of course, were aware that we were in a strong market and that the shares which you were purchasing that day would probably be worth more the next day and, you hoped, the next month and the next year—and so did I. The second point I want to make is—and I hope you will agree with me—that the investment which you made on that

day in that particular trust was not made just because the market was rising and because you might obtain some price advantage, but rather as a result of the intimate and detailed knowledge of this security, gained by reason of the educational work which had been done by me over the previous months.

In trying to explain to you how these sales are made, please do not assume that a situation such as I have just outlined is the isolated case, because in actual experience it is the way these shares are sold. The isolated case would be for me to call you up "cold turkey" and have you buy shares in this or any other open-end fund, just because the market was advancing.

Will you be patient with me a minute longer and let me summarize? If possible, I would like to leave these toughts in your minds, and they are as follows: That after 8 years of selling nothing but open-end trusts, I am able to come before you and make the definite statement, based on my own personal and intimate contact with the sales end of this business, that these shares have been sold only through the legitimate investment banking channels which are available to us; that these trusts have been sold to small and large investors, trust funds, and institutions, and, furthermore, that they have been sold with complete disclosure of all facts and only after considerable educational work has been done.

In closing, let me remind you that the sales which I have been talking about, and which have run into many millions of dollars, have all been made in the last 8 years, following the greatest collapse in the financial markets that this country has ever seen, and at a time when both the buying public and the investment dealer were more critical and more skeptical than ever before in the history of this country.

Thank you.

Senator WAGNER (chairman of the subcommittee). Are there any questions?

Senator HERRING. No; I believe not, thank you.

Senator HUGHES. No, thank you.

Senator WAGNER (chairman of the subcommittee). Thank you, sir. We shall next hear from Mr. Robert S. Adler, representing Selected American Shares, Inc.

STATEMENT OF ROBERT S. ADLER, PRESIDENT AND DIRECTOR, SELECTED AMERICAN SHARES, INC., CHICAGO, ILL.

Senator WAGNER. All right, Mr. Adler; will you proceed when you are ready, please?

Mr. ADLER. My name is Robert S. Adler, of Chicago, Ill. I am an officer and director of Selected American Shares, Inc., an open-end management investment company, with assets of about $10,000,000. It was organized during 1932. I am also an officer and director of two other companies, not publicly owned, one of which performs the function of sponsor and principal distributor of the shares, and the other of which performs the function of manager of Selected American Shares, Inc.

Although I have some views concerning various sections of this bill, and later shall make one or two brief references, I shall save you from repetitious discussion, and direct myself primarily to one section.

I want to make it very clear that my statement is entirely from the point of view of open-end management investment companies, with which general field I have had over 7 years of intimate experience.

Senator WAGNER (chairman of the subcommittee). Mr. Adler, I am sorry to interrupt you, but we have just learned that a vote is being taken over in the Senate, and we shall have to suspend at this point. I am sorry we shall not be able to hear all of your statement today.

Very well, gentlemen; we shall recess at this time until tomorrow morning at half past ten.

(Thereupon, at 4:10 p. m., an adjournment was taken until tomorrow, Thursday, Apr. 18, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

THURSDAY, APRIL 18, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, and Downey.

Present also: Senator Tobey.

Senator Wagner. Gentlemen, the subcommittee will come to order, if you do not mind—and I added that last because of the noise in the room.

Senator Tobey, won't you come up close to the committee table?

Senator Tobey. Mr. Chairman, I am not on this subcommittee.

Senator Wagner. That is all right. Subcommittees are only a convenience in the dispatch of the full committee's business. You have the same right to be here, if you wish, that any other member of the full committee has.

Senator Tobey. I thank you, Mr. Chairman. I will be glad to be a listener.

Senator Wagner. Mr. Adler, you represent Selected American Shares, I believe.

Mr. Adler. Selected American Shares, Inc.

Senator Wagner. Very well. You may proceed with your statement.

STATEMENT OF ROBERT S. ADLER, CHICAGO, ILL., OFFICER AND DIRECTOR, SELECTED AMERICAN SHARES, INC.

Senator Wagner. Very well. Will you proceed now?

Mr. Adler. I am Robert S. Adler of Chicago, Ill., an officer and director of Selected American Shares, Inc., an open-end management investment company with assets of about $10,000,000. It was organized during 1932. I am also an officer and director of two other companies, not publicly owned, one of which is the sponsor and principal distributor of the shares, and the other of which performs among other business the function of manager of Selected American Shares, Inc.

Although I have some views concerning various sections of this bill, and later shall make one or two brief references, I shall save you from repetitious discussion and direct myself primarily to one section. This does not mean that I have no difficulty with a number of other sections, however.

I want to make it very clear that my statement is entirely from the point of view of open-end management investment companies, with which general field I have had over 7 years of intimate experience.

Let me say first that I fully subscribe to the statement made to this committee by Commissioner Matthews, when he said:

> There is no doubt of the need of effective and comprehensive regulation. A form of control which is less than that may be about as dangerous to the public as complete freedom from administrative restraint. I would be very much opposed to any program which, under the mask of regulation, sought to do more than to impose those restraints upon management which are really necessary for the protection of investors, but any course which does not impose those restraints may be very misleading to those whom it professes to protect.

Senator WAGNER. Then that represents your view of the proposed legislation?

Mr. ADLER. No, sir; I am here quoting Commissioner Matthews.

Senator WAGNER. But you said you fully subscribe to that statement.

Mr. ADLER. I said I fully subscribed to that statement, yes.

Senator WAGNER. And that represents your view.

Mr. ADLER. Yes, sir; but you understand I am here quoting Commissioner Matthews.

Senator WAGNER. Yes. I understand. You may proceed.

Mr. ADLER. I particularly urge your attention to the Commissioner's words:

> I would be very much opposed to any program which, under the mask of regulation, sought to do more than to impose those restraints upon management which are really necessary for the protection of investors * * *.

In my opinion section 11 provides one of a number of examples of a program which seeks to do more than impose necessary restraints.

This section says that a promoter of a new investment company may not serve in any capacity with such new company if within 5 years he has been a promoter of another investment company. (I might say parenthetically the word "promoter" is nowhere defined in the act, and being a very broad term it may be very inclusive as to the persons who may be brought within the category. Probably even the lawyers who drew the documents might be included, though Mr. Schenker assured Senator Taft he had seen to the exemption of lawyers.) Section 11 also provides that the Commission has the power to exempt if, after giving due weight to certain specified factors, it finds that an exemption is consistent with the purposes of the bill.

During the testimony relating to this section, Senator Frazier asked why, if people were doing an honest business, they should organize more than one company. I should like to try to answer Senator Frazier's question.

This bill provides for classification of investment companies. It also provides for the notification to and approval by shareholders of fundamental changes of management policy. These factors indicate a recognition of the need for different types of investment service by various investors. There has also been much discussion concerning capital structure and of the distinct differences between open-end and closed-end companies and a number of other types. These discussions likewise indicate that different types of companies may very properly exist.

Now let us ask ourselves a few questions.

Is there any reason why a person managing, let us say, an investment company maintaining a highly diversified portfolio should not organize another investment company devoted entirely to securities of one industry such as, for example, aviation or chemicals? Is there any reason why the organizer of an investment company placing its principal emphasis on common stocks should not also manage one whose portfolio is primarily in bonds? What possible reason can there be to assume that a person organizing a company which is essentially devoted to investments in the country's leading well-established companies should not also organize another company to participate in the furnishing of venture capital to new enterprise?

Senator WAGNER. If, say, you organize a company to deal entirely in aviation stocks?

Mr. ADLER. Are you asking me if I have done so?

Senator WAGNER. No. You were suggesting that that might be done. Is there any objection to the organization of an investment company which would deal entirely—did you say—in aviation stocks?

Mr. ADLER. Yes, sir.

Senator WAGNER. Would you call that a diversified-investment company?

Mr. ADLER. It might very well be a diversified-investment company, with the meaning as between various companies within that particular industry, it is diversified.

Senator WAGNER. But in a case like that I am sure you agree that those who invest their money in such an investment trust should have absolute notice that the money is to be invested only in aviation stocks.

Mr. ADLER. Oh, definitely so.

Senator WAGNER. Well, that is my point. In other words, if I give my money to an investment trust with that understanding, then I know that my money will go into such stocks.

Mr. ADLER. Yes, sir; definitely so. But the point I am trying to make is that the mere fact an organizer of an investment company organizes one which is essentially a diversified company over a lot of different types of industries, should not mean that he should be barred from organizing one—or, rather, I raise the question here: Is there any reason why he should be barred from organizing one devoted to diversification among aviation companies?

Senator WAGNER. What prompted the question was this: There has been some testimony here, very early in our hearings, when we heard of companies that indulged, in many instances, at least, in looting—and you read some of that testimony, I take it?

Mr. ADLER. Yes, sir.

Senator WAGNER. Where some of such companies did represent that the money was to be invested along certain diversified lines, and then, without any notice to their stockholders, the money was taken and invested in some venture of some kind.

Mr. ADLER. That is an entirely different thing.

Senator WAGNER. You disapprove of that sort of thing, do you?

Mr. ADLER. Definitely I do.

Senator WAGNER. You may proceed with your statement.

Mr. ADLER. Again, is it not a fact that some investors may wish to place their funds in a company which has as its principal objective the

obtaining of dividend and interest income, while others may desire to place their funds much more at the risk of the market in an attempt to seek capital appreciation?

Now, gentlemen, the answers to these questions make it clear to me that different types of companies have their proper place in the scheme of things, and may very well be organized and operated by perfectly honest men attempting to do an honest job.

Mr. Schenker said, "The basic philosophy of that type of institution should be—you turn your savings over to us and we will manage them." I do not believe that the responsible elements in this business disagree with that philosophy. Is there anything inherent in the starting of another investment company, particularly of a different kind and to meet a different need, though not necessarily so, which contravenes such philosophy? I do not think so.

You have been told that one cannot organize bank after bank. Mr. Bunker made quite clear to you, I hope and believe, the vast differences in the true nature of the institutions. But even if the comparison were a fair one, let us examine the facts. I have been unable to find in the National Banking Act, any restrictions against starting a new bank on the ground that the organizers have already organized, within any period of time, another bank. In fact, I am advised that if the Comptroller of the Currency does not find that the location for a proposed national bank already has adequate facilities, he is required to permit the organization after the promoters have satisfied the other relatively simple and reasonable requirements.

True, there are minimum capital requirements, but for investment companies these have been dealt with in section 14 of the bill.

You have heard that section 11 was designed, in part, because the S. E. C.'s study indicated that in a great many instances the formation of investment companies of all kinds was not predicated upon any inherent belief in the soundness of the particular company, but rather was for the purpose of "switching," or having merchandise which the distributor could sell.

Now I ask you to remember in considering the S. E. C. testimony in this direction that the abuses arising out of those recurrent promotions were related entirely to two general classes of companies: (*a*) Those unrestricted companies which engaged so largely in cross ownership, circular ownership, and in the pyramiding of company upon company, as in the *United Founders case*; and (*b*) the unit type, or fixed investment trusts, some of which the record did indicate made a practice of switching. But I am not speaking of either of these classes of companies. Neither S. E. C. studies nor their testimony indicated that switching from one open-end management company to another organized by the same sponsor was engaged in to any important degree. It has not been shown at all that the organization of more than one company of the open-end management type by the same sponsor had any such motive.

On the contrary, the sponsor of an open-end management company has little incentive to promote switching, particularly if he has an interest in the continuing management. Reference was made in the S. E. C. testimony to the organization by one sponsor of several companies within 1 year. The inference was clear that No. 2 was created to enable the sponsor to switch investors out of No. 1; and that No. 3 to switch investors out of No. 2, and so on. But these

companies were organized within 1 year. It is not reasonable to suppose that the sponsor would have spent the substantial amount of time and money to organize a second one, even before the first one had an opportunity of becoming sufficiently large to have anything from which to switch. It would appear rather that if the motive were to provide such a medium, the second would not have been organized until the first one had—in the words of Mr. Schenker—"lost its sex appeal." Remember two things: first, they were started in 1932 when any sort of securities were extremely difficult to sell; and, second, they all had different investment objectives.

So you see, gentlemen, the answer to Senator Frazier's question is that an honest man may very well organize more than one investment company and may do so very creditably.

Of course, even if the contention of the proponents of this bill were correct, the principal stated objective of this section would not be achieved. There is nothing in any law—and there should be nothing—to prevent an investment dealer from advising his clients to dispose of one investment and acquire another. There is no restriction on the extent to which he may advise his customer to shift from one bond to another, or from one stock to another. This is the basis of a large amount of the securities business of the Nation. If a dealer believes that his clients' funds are not properly invested in one situation, he will undoubtedly advise its disposition and the acquisition of something else. This he will do, and often does, in investment company shares just as readily as he does in any and all other securities.

In passing, it should be noted that the very possibility of a dealer having his customer dispose of particular shares is an incentive of great force to the sponsor-manager of an open-end company to obtain the most efficient results, lest he lose through redemptions a portion of the assets which produce for him a management compensation.

Aside from not achieving the objectives, let us see for a moment what this section does to existing units in the business. It creates great inequities. It would tend to "freeze" the business of distribution of open-end management companies' shares as it now is. Those distributing organizations which can reach different investors through different types of existing companies, those that have several would be permitted to continue to do so, but those which are not now doing so would be unable to participate in the organization of new companies to fill a different need.

In other words, gentlemen, they could not expand their own business in this way. It would serve to penalize those very sponsors who, on the S. E. C.'s theory of section 11, are least subject to criticism. That is to say, those who have sponsored only one company would now be in a position of being unable to reach a different type of investors, whereas those who already have several companies have the advantage of continuing to reach these different people and serve their differing investment needs.

Now, Mr. Chairman, if this limitation is sound, why is it not sound to prohibit an insurance company from issuing several different types of policies; or a bank from offering to clients different types of trust service; or a lawyer from practicing in different branches of the legal profession? This is manifestly an unfair situation in which to place responsible persons who may desire to extend their ability and experience.

Now it is true that subsection (d) provides that the Commission may exempt a promoter from the restrictions contained in the section, but it is to be doubted whether it is equitable to so limit the right of a citizen to employ himself in his chosen field. This is the more true when the restrictions cannot be demonstrated as necessary to the solution of the stated objectives. Competent legal counsel incidentally has even raised the question of the constitutionality of such a provision. But I am not a lawyer and am not qualified to speak on that question.

Subsection (b), which the Commission did not touch upon in its testimony, would make it unlawful for the organizer of a new company to act as adviser or underwriter for it, if at the same time he is serving another investment company. This prohibition raises the fundamental question of whether there is anything inherently wrong about an adviser or underwriter increasing his own business by organizing a new company.

I am frank to say that I believe there is nothing wrong in such action. But if the present Commission, or any future commission, believes that there is something wrong in such action, I wonder whether the exemption provision in paragraph (d) would gain for such a person the permission to further his own business—even if he were an honest man doing an honest job.

Summarizing section 11, I believe—

First. More than one company may very properly be started by one person.

Second. The abuses, which section 11 presumably is designed to prevent, have not been proved to exist in the open-end management field.

Third. Even if such abuses were prevalent, section 11 would not cure them, in my judgment, of course.

Fourth. Section 11 would create great inequities and work unnecessary hardships.

Fifth. It would, upon totally inadequate grounds, limit the right of a citizen to engage in new business endeavors.

There is no doubt in my mind but that reasonable standards for open-end investment companies now exist and can be and probably should be more fully developed. If companies can meet such standards, which should be clearly stated in the law, there is no reason to prohibit their organization merely on the ground, and I repeat, merely on the ground that those starting them have within any period of time participated in the formation of any other investment company.

Section 10 has been dealt with by other witnesses. I wish to add, however, that I believe that the numerous and varied limitations upon persons who may or may not be on boards of directors, or who may serve in other stated capacities, would, in many cases, produce a segregation of interests which will needlessly upset existing situations; will make better investment management much more difficult to obtain and will, with few exceptions, be contrary to the interests of the shareholders of most of these particular companies of which I am speaking; that is, open-end management companies.

Many of the affiliations (such as those of underwriter and manager), particularly the ones in subsections (d) (4) and (5), have not been shown in the case of open-end management companies, to produce a detrimental conflict of interest. To the contrary, the reports of the

S. E. C. to the Congress clearly indicate, to the best of my knowledge, no record of existing or demonstrable abuses based on such conflict, and insofar as measurable performance records are concerned, no need whatsoever for such prohibitions.

Let me conclude: I am in favor of the development of sound regulation of investment companies. I believe that it can and should be accomplished and I shall be happy to assist in its accomplishment. I believe that there are a number of principles embodied in this bill which can, with proper treatment, lead to such an end. I do not believe that either this bill, as it now stands, or its authors' fundamental approach to many of the problems, is the correct path to those proper restraints upon investment companies, which are really necessary for the protection of investors.

Thank you.

Senator WAGNER. We thank you very much, Mr. Adler. And I might suggest to you, since you say, in the latter part of your prepared statement, that you believe there should be some regulation, and all of the responsible members of your industry seem to believe that too; and since, further, you suggest that this bill should be made into a bill for effective regulation, you ought to follow that up by making some suggestions to the subcommittee along that line.

Mr. ADLER. Mr. Chairman, I would like just to correct that impression if I have left it with you. I stated that I did not believe either this bill as it now stands or its authors' fundamental approach to many of the problems, is the correct path to those proper restraints upon investment companies which I have in mind.

Senator WAGNER. Well, I referred to what you said just before that. Will you read from the sentence just before you made that statement?

Mr. ADLER. I said I believe there are a number of principles embodied in this bill which could, with proper treatment, lead to such an end.

Senator WAGNER. Yes. Therefore are you not willing to present some suggestions as to what you think they would be?

Mr. ADLER. I am very willing to present suggestions.

Senator WAGNER. I know the subcommittee would welcome any suggestions from you.

Mr. ADLER. Thank you.

(Thereupon Mr. Adler left the committee table.)

Senator WAGNER (chairman of the subcommittee). Mr. Gardiner.

STATEMENT OF WILLIAM TUDOR GARDINER, CHAIRMAN, INCORPORATED INVESTORS, BOSTON, MASS.

Mr. GARDINER. Mr. Parker will follow me, and we will be very brief.

My name is W. T. Gardiner, chairman, Incorporated Investors, Boston.

In order to conserve the time of the committee Mr. Parker and I have condensed our statements, and will touch briefly on two parts of the bill that particularly affect the structure of our company.

We agree with the general criticism of the bill already expressed.

Let me just say a word about the prohibition in the bill against an officer of an investment company serving as a director of a company whose stock is in the portfolio.

It so happens that Mr. Parker is a director of Lowe's, Inc., and I am a director of United States Smelting, Refining & Mining Co. At the present time stocks of both of those companies are in our portfolio.

We feel there is no conflict of interest in that situation, and we feel that we should not be required, by a statute, to separate outselves from the world of active affairs.

Section 10 (d) as far as my companies go, requires segregation of management and sales contrary to the practice that we have followed for 15 years.

The section is not entirely clear, but it appears that segregation could be avoided only, in our case, by disqualifying as investment officer or manager the three principal executives in our organization. This provision does not seem fair in purpose, but other speakers will cover this section in greater detail, Senator Wagner.

Section 20 (b) of the bill prohibits the sale of voting trust certificates contrary to the practice we have followed for 15 years.

It is not our experience that these two practices of our company have heretofore met with any considerable objection. We have grown to have 32,000 stockholders and $47,000,000 of assets. We meet the requirements of the regulatory measures, and are qualified to do business in 24 States.

This is quite a lot of regulation, and Mr. Taliaferro, who will follow today, will take up the matter of State regulation in greater detail. He will refer to the effort of the State "blue sky" commissioners to develop and improve a law that some of them hope may become a uniform law for the regulation of the registration of securities to be offered for sale in any State.

Mr. Taliaferro will explain the terms of that act to you, but let me indicate in advance of his statement that it is not a complicated act, one that covers many important matters, and it is different. For instance, it prohibits such matters as self dealing, trading against the trust, and selling down the river, that we have discussed here. It limits such matters as charges for management or for sales cost, and such matters as borrowing by the trust. It insures such matters as proper custodianship of securities, diversification, reports, and description of source of dividends. That will indicate to you the extent of the regulation to which we are now subject.

Senator WAGNER. That is in what State?

Mr. GARDINER. That is adopted in Ohio; and in more or less identical language in your State, Senator Tobey; and is under consideration in other States.

Will you now permit Mr. Parker, president of Incorporated Investors, and one of the founders, to explain to you why this form of investment company, which is condemned in this bill, was adopted by Incorporated Investors?

Senator WAGNER. Mr. Gardiner, might I ask you just for my information, though it is purely an aside here: There was quite a distinguished citizen by the name of Gardiner who became known as a trustee, I believe in Massachusetts. I know that the State had great confidence in him, and that he had very large sums of money in his control as trustee. Does he happen to be related to you?

Mr. GARDINER. That was my father, and I trained in his office in 1916.

Senator WAGNER (chairman of the subcommittee). All right, Mr. Parker.

STATEMENT OF WILLIAM A. PARKER, PRESIDENT INCORPORATED INVESTORS, BOSTON, MASS.

Mr. PARKER. Senator Wagner, my name is William A. Parker. I am president of Incorporated Investors. I was one of the founders of Incorporated Investors 15 years ago. There has been no material change in our company or in its policies in those 15 years. A corporate form seemed desirable to us and we added to this a voting trust. Our voting trust agreement states that this was "to secure stability and harmony in the affairs of said corporation, and to assure as far as possible a conservative, permanent management."

The voting trust made it impossible for any outsider to force a change in the policy or the personnel of the company. Thus we had virtually a Massachusetts trust with a corporate form of existence.

The same group controls the management of the company and the distribution or sale of its shares. We have been able to select our own dealers and thus control how and by whom our stock should be sold. We believe that this is most advantageous. We have been very proud of the kind of dealer who has distributed our stock. It is plainly set forth in our literature that control of sales and management is identical and also that the shareholders have no vote. People have desired to invest their money with us presumably because they had confidence in our judgment and because they did not want to go to the bother or risk of selecting common stocks themselves.

Senator, I have been an officer of this company for 15 years and in that time I have talked with hundreds and hundreds of our shareholders. I don't suppose that this committee has any conception of how completely we live in a goldfish bowl. We have always issued reports quarterly with full disclosure of our affairs. Many of our shareholders have been critical of individual securities in our portfolio, and sometimes of investment policies, often constructively critical. Nevertheless, in all these years, I have never had a shareholder criticize our particular set-up of management and sales, and never a one who even intimated that he wanted a vote.

We were very glad in 1936 that we controlled sales as well as management. In the fall of that year we thought the market was pretty high and we closed—that is we stopped offering further shares. Subsequently it turned out that we were wise and that it was better for us not to have continued to take in new money from the public for investment at those levels. We could make this decision readily because we had no contract with an outside distributor and though many of our dealers begged us not to close, we were in a position where we could exercise our own judgment. We reopened and again offered shares in 1938, when the market was substantially lower. We see no reason for condemning identity of sales and management or requiring investors to vote when they do not wish to do so.

There is one point on which I am anxious not to have my position misunderstood. I disapprove entirely of this bill in its present form,

and I believe that its philosophy of discretionary powers delegated to commission rule is wrong and also unnecessary.

Most of the abuses which have horrified us all are punishable under existing common law, others would be no longer practical under the full disclosure requirements of the S. E. C. Act. Still others could be competently taken care of by the N. A. S. D. under the Maloney Act.

Senator WAGNER. I thank you very much.

(Thereupon Mr. Gardiner and Mr. Parker left the committee table.)

Senator WAGNER (chairman of the subcommittee). Mr. Louis Curtis.

STATEMENT OF LOUIS CURTIS, PARTNER OF BROWN BROS., HARRIMAN & CO., BOSTON, MASS.

Mr. CURTIS. Mr. Chairman and gentlemen of the subcommittee: My name is Louis Curtis. I am a partner of Brown Bros., Harriman & Co., private bankers, Boston.

I am also a trustee of an investment company but I am here not on that subject in any way. I am going to talk purely about the custodian features of this bill.

Section 17 (g) authorizes the Securities and Exchange Commission to require that the securities of a management investment company be in the custody of an institution having qualifications required in paragraph (1) of section 26 (a) for the trustees of unit investment trusts.

Section 26 (a) says that no underwriter may sell shares of a unit investment trust unless the trust indenture designates as a trustee an incorporated institution authorized by law to exercise corporate trust powers, subject to supervision or examination by Federal or State authority, with a capital and surplus not less than a minimum to be specified by the Securities and Exchange Commission.

The objection of Brown Bros., Harriman & Co. to these sections is that the Securities and Exchange Commission is authorized to require that the custodian of the securities of an investment company be an incorporated institution. That leaves out private banks. We maintain that the ability and propriety of an institution to fulfil that function is not dependent on its being incorporated and specifically authorized by law to exercise corporate trust powers. We believe that any institution which is subject to examination and regulation by Federal or State banking authorities, as the Banking Acts of 1933 and 1935 require of anyone who conducts a banking business, is entirely qualified to be such a custodian, whether it is incorporated or not.

We therefore ask that the above sections of the bill and any other sections which by amendment to the bill as originally printed may contain similar restriction be enlarged to include "banks" as defined in this bill and in the Securities Exchange Act of 1934. This would qualify as custodian a private bank which conducts a general banking business, and is subject to examination and regulation by Federal or State banking authorities, provided, if it is deemed wise, that the "bank" has a combined capital and surplus of such minimum amount as the Securities and Exchange Commission may specify.

Our unincorporated bank, established in 1818, has deposits of over $100,000,000 and a combined capital and surplus of over $13,000,000,

with unlimited liability on top of that, it has acted as custodian for investment companies for 12 years. I do not believe that the drafters of this bill intended to eliminate——

Senator WAGNER (interposing). I do not either, and if I may interrupt you right there, I think that correction will have to be made in the bill.

Mr. CURTIS. I was just going to say: I do not believe that the drafters of this bill intended to eliminate publicly examined and regulated private banks from the custodian field, and therefore regard our requested amendment of the bill as more of a technical correction than a change of policy.

Senator WAGNER. Mr. Schenker has already spoken to me about that.

Mr. CURTIS. Well, that is all I have to say. Mr. Schenker tells me that he has no objection to this amendment.

Senator WAGNER. I agree with you.

(Thereupon Mr. Curtis left the committee table.)

Senator WAGNER (chairman of the subcommittee). We shall next hear from Mr. Richard Taliaferro. Will you proceed, please?

STATEMENT OF RICHARD N. TALIAFERRO, PRESIDENT, FIDELITY FUND, INC., BOSTON, MASS.

Mr. TALIAFERRO. Mr. Chairman, I am Richard N. Taliaferro. I am appearing before this committee as president of Fidelity Fund, Inc., organized in 1930; it is an open-end diversified investment company. This company has about 2,000 shareholders, and total assets of about $4,000,000. I have been asked by other trusts, who have examined this statement, to read letters which they have addressed to me concerning such statement. The total assets of the trusts which represent these letters, combined with those of the Fidelity Fund, Inc., amount to approximately $30,000,000.

Throughout these hearings, and from our knowledge of the proposed legislation, I have been impressed with one thing—namely, if legislation is to be drawn covering within one title the whole investment-trust business, a great deal of discretion must, perhaps, be given to the Securities and Exchange Commission. Repeatedly, in the testimony, controversial points have been brought up concerning certain provisions which are not applicable to the company, or type of company, whose representative was then testifying.

There is valid reason, in my opinion, for this confusion. If, for example, a bill with a single title were to be drawn to regulate savings banks, cooperative banks, and commercial banks, the same confusion would arise and the final result would be that a great amount of discretion would have to be given to the regulatory body. It is obvious that the functions of these three institutions are quite separate and distinct.

The Securities and Exchange Commission has, in fact, made distinctions in its own classification of investment companies. Yet, when one gets into the heart of the bill, one becomes more and more bewildered because there has been an attempt made to cover so many diverse problems. The net result has been that the Securities and Exchange Commission finally, and perhaps necessarily, asks for many discretionary powers.

It seems to me that the sane approach to this problem is the simplest one: recognize at the outset that these diverse problems exist, and consider a separate title to cover each broad classification, such as:

Title I. Open-end diversified management companies.

Title II. Closed-end management companies.

Title III. Face-amount certificate companies.

Title IV. Unit investment trust.

Title V. Periodic payment plan certificates.

Now, if I can, I should like to convince you that the problem of drafting a separate title for open-end diversified investment companies would not involve undue hardship, as much work along these lines has already been done. For example, the division of securities of the State of Ohio presented to the annual meeting of the National Association of Securities Commissioners, at Skytop, Pa., last fall, a memorandum on the regulation of open-end investment companies, which has become known as "Q–3." The Securities Commissioners adopted this memorandum in open convention as a guide for the regulation of those open-end companies whose shares are offered for sale in various States. Q–3, as such, has been adopted by the State of Ohio and is being closely followed by other States, such as Michigan, Minnesota, Alabama, Kentucky, and New Hampshire.

A great deal of thought and regulatory experience was drawn upon in drafting Q–3. I feel that your committee should have the benefit of this work, and for that purpose I should like to present a copy of the Q–3 regulatory provisions for the record.

(Document entitled "Q–3 Application for Qualification of Investment Trust Shares" is as follows:)

Q–3. Application for Qualification of Investment Trust Shares

The offer or disposal of shares of an investment trust of the management type is hereby defined to be an offer or disposal on grossly unfair terms unless the articles or other instruments under which the trust, or the sponsor, manager, or custodian thereof, is created, organized, or administered are effective to:

1. Prohibit all officers, directors, or trustees of the trust or of the manager of the trust from dealing for or on behalf of the trust with themselves, as principal or agent, or with any corporation or partnership in which they have a financial interest.

(a) Such prohibition shall not prevent officers, directors, or trustees of the trust from having a financial interest in the trust, sponsor, or manager of the trust.

(b) Such prohibition shall not prevent the purchase of securities for the portfolio of the trust or sale of securities owned by the trust through a security dealer, one or more of whose partners, officers, or directors is an officer, director, or trustee of the trust, provided such transactions are handled in the capacity of broker only and provided commissions charged do not exceed customary brokerage charges for such service.

(c) Such prohibition shall not prevent the employment of legal counsel, registrar, transfer agent, dividend disbursing agent, or custodian or trustee having partner, officer, or director who is an officer, director, or trustee of the trust, provided only customary fees are charged for services rendered to or for the benefit of the trust.

(d) Such prohibition shall not prevent the purchase for the portfolio of the trust of securities issued by an issuer having an officer, director, or security holder who is an officer, director, or trustee of the trust or of the manager of the trust, unless at the time of such purchase one or more of such officers, directors, or trustees owns beneficially more than one-half of 1 percent of the shares or securities, or both, of such issuer and such officers, directors, and trustees owning more than one-half of 1 percent of such shares or securities together own beneficially more than 5 percent of such shares or securities.

2. Prohibit the retention in the portfolio of the trust of securities issued by an issuer any of whose officers, directors, or security holders is an officer, director, or trustee of the trust or of the manager of the trust if after the purchase of the securities of such issuer by the trust one or more of such officers, directors, or trustees owns beneficially more than one-half of 1 percent of the shares or securities, or both, of such issuer and such officers, directors, and trustees owning more than one-half of 1 percent of such shares or securities together own beneficially more than 5 percent of such shares or securities.

3. Prohibit the sponsor and manager of the trust, the officers and directors of the sponsor and manager, and the officers, directors and trustees of the trust from taking long or short positions in the securities issued by the trust.

(a) Such prohibition shall not prevent the sponsor from purchasing from the trust shares issued by the trust provided that orders to purchase from the trust are entered with the trust by the sponsor upon receipt by the sponsor of purchase orders for the shares of the trust and provied such purchases are not in excess of purchase orders received by the sponsor.

(b) Such prohibition shall not prevent the sponsor from maintaining a market for the securities issued by the trust in the capacity of agent for the trust.

(c) Such prohibition shall not prevent the purchase from the trust of shares issued by the trust by the officers, directors, or trustees of the trust, sponsor or manager at the price available to the public at the moment of such purchase provided there is on file with the Division an undertaking by the trust that purchases will be permitted for investment purposes only and that any sales of shares issued by the trust made by such persons less than 2 months after the date of purchase of any shares issued by the trust will be immediately reported to the Division of Securities.

4. Prohibit the lending of assets of the trust to the sponsor or manager, to officers or directors of the sponsor or manager, and to officers, directors, or trustees of the trust.

5. Require that securities owned by the trust and cash representing the proceeds from sales of securities owned by the trust and of shares issued by the trust, payments of principal upon securities owned by the trust, or capital distribution in respect of shares owned by the trust be held by a custodian or trustee which shall be a bank or trust company having not less than $2,000,000 aggregate capital, surplus, and undivided profits provided such a custodian or trustee can be found ready and willing to act.

6. Bind the trust upon the resignation or inability to serve of the of the custodian or trustee (a) to use its best efforts to obtain a successor custodian or trustee, (b) to require that the cash and securities owned by the trust be delivered directly to the successor custodian or trustee and (c) in the event that no successor custodian or trustee can be found, to submit to the stockholders, before permitting delivery of the cash and securities owned by the trust to other than a successor custodian or trustee, the question of whether such trust shall be liquidated or shall function without a custodian or trustee.

(a) Such limitation shall not prevent the termination of the agreement between the trust and the custodian or trustee by the vote of a majority of the shareholders of the trust.

7. Bind the custodian or trustee holding cash and securities owned by the trust, except as provided in paragraph 6 of this regulation.

(a) To deliver securities owned by the trust only upon sale of such securities for the account of the trust and receipt of payment therefor by the custodian or trustee, or when such securities may be called, redeemed, retired, or otherwise become payable.

(1) Such limitation shall not prevent delivery of securities for examination to the broker selling the same in accord with the "street delivery" custom whereby such securities are delivered to such broker in exchange for a delivery receipt exchanged on the same day for an uncertified check of such broker to be presented on the same day for certification.

(2) Such limitation shall not prevent delivery of securities of an issuer in exchange for, or conversion into other securities alone or cash and other securities pursuant to any plan of merger, consolidation, reorganization, recapitalization, or readjustment of the securities of such issuer.

(3) Such limitation shall not prevent the conversion by the custodian or trustee of securities owned by the trust pursuant to the provisions of such securities into other securities.

(4) Such limitation shall not prevent the surrender by the custodian or trustee of warrants, rights, or similar securities owned by the trust in the exercise of

such warrants, rights, or similar securities, or the surrender of interim receipts or temporary securities for definitive securities.

(5) Such limitation shall not prevent the delivery of securities as collateral on borrowing effected by the trust.

(6) Such limitation shall not prevent the delivery of securities owned by the trust as a redemption in kind of securities issued by the trust.

(b) To deliver funds of the trust only upon the purchase of securities for the portfolio of the trust and the delivery of such securities to the custodian or trustee.

(1) Such limitation shall not prevent the release of funds by the custodian or trustee for redemption of shares issued by the trust, for payment of interest, dividend disbursements, taxes, management fees, for payments in connection with the conversion, exchange, or surrender of securities owned by the trust as set forth in subparagraph 7 (a) (2), 7 (a) (3), and 7 (a) (4) above and for operating expenses of the trust.

8. Fix the factors and the method for the determination of the "asset value" and the "liquidating value" of the trust or its shares.

9. Prohibit the purchase of the securities of any issuer for the portfolio of the trust if such purchase at the time thereof would cause more than 5 percent of the total trust assets to be invested in the securities of any one issuer. The percentage determination referred to herein and in subparagraph (b) below may be made either at cost or at market provided one method or the other is adopted and consistently followed.

(a) This limitation shall not apply to obligations of the Governments of the United States of America or Canada or to obligations of any corporation organized under a general act of Congress if such corporation is an instrumentality of the United States.

(b) This limitation shall not apply to trusts the investment of whose funds is restricted solely to the securities of companies operating in a particular industry. In the case of such "specialty" trusts a prohibition shall be established effective to require that the assets of the trust shall be invested in the securities of not less than 10 companies and to prohibit the purchase of the securities of any issuer for the portfolio of the trust if such purchase at the time thereof would cause more than 10 percent of the total trust assets to be invested in the securities of any one issuer.

10. Prohibit the purchase of the securities of any issuer for the portfolio of the trust if such purchase at the time thereof would cause more than 10 percent of the securities of any such issuer to be held by the trust.

11. Prohibit the investment of any assets of the trust in the securities of other investment trusts except by purchase in the open market where no commission or profit to a sponsor or dealer results from such purchase other than the customary broker's commission.

12. Prohibit borrowing on behalf of the trust of amounts in excess of 10 percent of the gross assets of the trust taken at cost provided that any borrowing permissible hereunder shall be undertaken only as a temporary measure for extraordinary or emergency purposes.

(a) Such limitation shall not prevent the issuance and sale by the trust of bonds or debentures having adequate protective features for the holders thereof and for the securities of the trust junior thereto with a definite maturity date of not less than 5 years from the date of issue provided that the issuance and sale of additional bonds or debentures is prohibited if such issuance would increase the total amount of all bonds and debentures outstanding to an amount in excess of 25 percent of the total assets of the trust taken at cost or market, whichever is lower.

13. Prohibit the pledging, mortaging, or hypothecating in behalf of the trust of the assets of the trust taken at market to an extent greater than 15 percent of the gross assets of the trust taken at cost.

(a) Such limitation shall not prevent the pledging, mortgaging, or hypothecating of the assets of the trust in behalf of the trust to secure bonds or debentures issued as provided in paragraph 12 of this regulation.

14. Permit unrestricted transfer of securities issued by the trust.

(a) Such requirement shall not prevent the charging of the customary transfer-agent fee.

15. Prohibit the officers, directors, or trustees of the trust or other manager of the trust from employing the funds of the trust for the purpose of buying securities for the portfolio of the trust on margin.

16. Prohibit the officers, directors or trustees of the trust or other manager of the trust from making any short sales for the account of the trust.

(a) Such limitation shall not prevent any sale of securities by the trust where the trust owns at the time of such sale securities equivalent in kind and amount to those sold or where the trust owns at the time of such sale securities convertible into securities equivalent in kind and amount to those sold.

17. Prohibit the investment of funds of the trust in the securities of companies which have a record of less than 3 years continuous operation. Such period of 3 years may include the operation of any predecessor company or companies, partnership or individual enterprise if the company whose securities are proposed as an investment for funds of the trust has come into existence as the result of a merger, consolidation, reorganization or the purchase of substantially all of the assets of such predecessor company or companies, partnership or individual enterprise.

18. Prohibit the operation of the trust under any management contract which does not provide that such management contract cannot be amended, transferred, assigned, sold or in any manner hypothecated or pledged without the affirmative vote or written consent of the holders of a majority of the shares of the trust.

(a) It shall be further provided that in the event of the cancelation or expiration by its own terms of any management contract, no new management contract shall become effective without the affirmative vote or written consent of the holders of a majority of the shares of the trust.

19. Require that upon the death, resignation, or removal during any consecutive period of 12 months of more than one-half of the directors or trustees of the trust holding office at the beginning of such period, a shareholders' meeting shall be called forthwith for the purpose of electing an entire new board or to approve the selection of a new board where board members are not, under the instruments governing the operation of the trust, elected by shareholders.

20. Restrict the maximum load or commission to be charged upon the sale of common shares issued by the trust to 9 percent of the offering price to the public of such shares. As used in this paragraph, "offering price to the public" shall mean the asset value as hereinafter defined plus the load or commission charged adjusted to the nearest full cent. As used in this paragraph, "asset value per share" shall be determined by dividing the value of the net assets of the trust by the number of shares issued by the trust and outstanding plus the number of shares sold by the trust though certificates have not been issued at the time of calculation.

21. Restrict the maximum fee to be charged upon repurchasers of shares issued by the trust to 1 percent of the liquidating value per share. As used in this paragraph, "liquidating value per share" shall have the same meaning as "asset value per share" defined in paragraph 20 of this regulation. Any such repurchase fee shall be credited to the trust and not to the sponsor, directly, or indirectly.

22. Restrict the maximum charges per annum paid by the trust, inclusive of management fee but exclusive of interest or taxes, to not more than 1½ percent of the annual average asset value of the trust based upon computations of asset value made at least quarterly. As used in this paragraph, "Asset value of the trust" shall mean the value of the net assets of the trust plus the amount of funds borrowed for investment purposes. Proof that total charges for the last preceding year, or the last preceding 2 years if a trust has been in existence more than 2 years, have not exceeded the maximum rate above specified, shall constitute prima facie proof that total charges will not exceed such maximum in the future, provided an undertaking is given to the division that there will be furnished to the division annually and so long as the trust has securities qualified for sale in Ohio, a statement descriptive of such charges. Such statement shall be under oath and shall describe the nature of charges in the preceding calendar year, their dollar amounts, the percentage which such amounts represent of the annual average asset value of the trust for the preceding calendar year based upon computations of asset value made at least quarterly, and a list of any changes in charges contemplated at the date of such statement. Such statement shall be furnished on the fifteenth day of February or not later than 45 days after the close of the fiscal year of the trust if its fiscal year is not based on the calendar year. Where a trust has had an operating existence of less than 1 year, it shall furnish such proof with respect to probable charges as the nature of its operating experience and contemplated policies permits, together with an undertaking of the character above set forth.

23. Require that the trust redeem shares issued by it not more than 7 full business days after tender to the trust of the certificates for such shares at the asset value per share at the close of business on the day when such redemption is actually effected less charges permitted by paragraph 21 of this regulation. As used in this paragraph, "asset value per share" shall have the same meaning as in paragraph 20.

(*a*) Such limitation shall not prevent temporary suspension of redemption privileges in case of the closing of or restriction of trading on exchange markets as a result of which disposal by the trust of the securities owned by the trust becomes impossible. In such event redemption shall be made within a reasonable time after such markets are reopened and unrestricted.

24. Require the submission to investors of reports not less often than semi-annually of the operations of the fund, based at least annually upon an audit by independent public accountants, which reports shall clearly set forth, in addition to the information customarily furnished on a balance sheet and profit-and-loss statement, a statement of all amounts paid to security dealers, legal counsel, transfer agent, disbursing agent, registrar, or custodian or trustee, where such payments are made to a firm, corporation, bank, or trust company having a partner, officer, or director who is an officer, director, or trustee of the trust.

(*a*) A copy of all reports submitted to security holders of the trust shall be furnished forthwith to the Ohio Division of Securities.

25. Require that whenever dividends are paid out of capital gains such fact shall be clearly revealed to shareholders and that the basis of calculation shall be set forth.

The effective date of this regulation shall be May 20, 1939, with respect to all applications for qualification not filed prior to said date. Trusts for which applications have been filed prior to May 20, 1939, and which are registered by qualification prior to July 1, 1939, shall comply with the provisions of this regulation by July 1, 1939. Trusts now having shares registered by qualification for sale in the State of Ohio shall comply with the provisions of this regulation by December 1, 1939.

Mr. Taliaferro. For your convenience, I have a list of the points covered by this regulation, and they are as follows:

1. Self-dealing.
2. Ownership of securities in a company having common officers and directors with a trust.
3. Long or short position in shares of the trust.
4. Lending of assets of the trust.
5. Custodian arrangements.
6. Successor custodian.
7. Handling of funds by custodian.
8. Determining asset value.
9. Limit on investing in one security.
10. Limit on investing in the securities of one company.
11. Purchase of securities of other trusts.
12. Limitation on borrowing.
13. Limitation on pledging of assets.
14. Method of transfer of shares of the trust.
15. Margin buying by the trust.
16. Short sales by the trust.
17. Age of companies for portfolio purchase.
18. Management contracts.
19. Change in board of directors during a period of 12 consecutive months.
20. Maximum load.
21. Maximum repurchase charge.
22. Maximum operating expenses excluding taxes and interest in relation to total assets.
23. Maximum of delay for redemption.
24. Reports for shareholders.
25. Disbursements of capital gains as dividends.

Senator Wagner. How about the shareholders? Does it specify the time when these reports are to be made?

Mr. Taliaferro. These are the items regulated. The regulations themselves are in the exhibit.

Senator WAGNER. Yes.

Mr. TALIAFERRO. This set of rules would appear to be a case of practical regulation in cooperation with a regulatory body set up for that purpose. Most of the open-end trusts, which are currently selling securities to the public, are registered in Ohio, and all are operating in accordance with these regulations. Furthermore, all open-end trusts, registered in Ohio, must change their charters or trust indentures, or execute a contract, so as to comply with this regulation on or before August 1, 1940, in order to maintain qualification in that State after that date. Q–3 consists of 25 rules and, in effect, draws up requirements for operating a trust from the stockholder's point of view.

As most investment trusts have agreed to qualify with Q–3, the adaptation of your legislation to the similar requirements would be a material saving in legal expense to the shareholders of investment trusts, and would remove from the whole investment trust picture the uncertainty of whether or not a given trust can operate in a manner anywhere near its present operations, after the passing of this Federal legislation.

We do not mean to imply that these regulations should be adopted in their present form, but that they are presented merely to provide a constructive suggestion when consideration is given to legislation. They may not cover all objectives, but they certainly cover the principal ones and, more important, a title drawn along these lines will give us a workable approach to legislation.

The point which we wish to stress is that, in adopting these rules, no extreme hardship has been created for the industry; and, still more important, we know just what we can do and what we cannot do. In short, we can live under this type of regulation. Yet, even here some discretion must be given in certain instances; but the power used has been that of exemption from certain provisions by certain companies where the Commission, after careful study, has found the exception not to be to the detriment of shareholders and the public. We are not adverse to such discretion, and, in fact, feel that it must necessarily be given.

Senator WAGNER. The regulations that you just mentioned, and which you introduced into the record, were provided by law or by a commission?

Mr. TALIAFERRO. They were provided by regulation; they are not a statute.

Senator WAGNER. They are in the law itself?

Mr. TALIAFERRO. They are not a statute.

Senator WAGNER. They are not a statute?

Mr. TALIAFERRO. They are not a statute; they are regulations.

Senator WAGNER. They are regulations by a public body?

Mr. TALIAFERRO. Regulations by the Securities Division of the State of Ohio.

Senator WAGNER. So it is a pure regulation?

Mr. TALIAFERRO. That is right; but it is very specific; and I should like to say in addition that a great deal of time was spent by these commissioners with people in the investment trust business. I happened to be at the convention in Sky Top, when this suggestion was made by the Commissioner of Ohio, and even there his whole regulation was changed, before being presented, after talking with several of us who were representing different trusts.

Senator WAGNER. That is what we are trying to do here; we are trying to hear all sides.

Mr. TALIAFERRO. I think this is an opportunity for us to be heard, and where we can be heard.

Senator WAGNER. Yes.

Mr. TALIAFERRO. However, Senator, I must say that the S. E. C. did not show us the same cooperation that we are receiving from your committee.

Senator WAGNER. Let me ask you this question, please: Among those regulations, is there one that provides for a notification to stockholders if there should be a change of fundamental policy of an investment trust? I do not recall whether you stated that or not.

Mr. TALIAFERRO. That is not.

Senator WAGNER. It is not?

Mr. TALIAFERRO. Not before it happens, unless you can say that a quarterly report would contain such information, showing the list of securities.

Senator WAGNER. I wondered whether there was a prohibition, among these regulations, that there shall not be any change of policy without first having the approval of the stockholders?

Mr. TALIAFERRO. There is not; but I can see no objection to such a prohibition.

Senator WAGNER. Yes.

Mr. TALIAFERRO. I should like to speak briefly on the regulation of sales activity of open-end trusts. Economically, it is best to put to use those things which one has, rather than to create additional tools. The Maloney Act set up an organization, the National Association of Security Dealers, for the supervision of operations of investment dealers for public interest. A committee of this association has been formed to administer the sales problems of investment trusts. The operations of the N. A. S. D. are under the supervision of the Securities and Exchange Commission. All active distributors of investment trusts are now registered under this group. Therefore, for the purpose of simplicity and economy, I earnestly suggest that all rules and regulations of sales activities, which your committee thinks are required in this bill, be specifically placed under the jurisdiction of the N. A. S. D., which should be required to have a permanent committee to deal with these problems.

These recommendations are submitted with the knowledge that regulation would be beneficial to our business and would keep in it persons of high character who give substantial benefits to the group of shareholders whose money is entrusted to their care.

Senator WAGNER. Thank you very much.

Mr. TALIAFERRO. Shall I put these letters in the record?

Senator WAGNER. Yes, please.

(The letters referred to are as follows:)

BOSTON FUND, INC., *April 15, 1940.*

Regarding investment trust bill S. 3580.

Mr. RICHARD TALIAFERRO,
Washington, D. C.

We understand that you are going to urge that consideration be given by the Subcommittee on Banking and Currency to redraft the bill so that separate titles will cover each broad classification of investment company. This step would in our opinion enable the committee to draft specific legislation for the most part which we feel is highly desirable. We feel that only in this way can practically

all the discretionary powers given the Securities and Exchange Commission under the present bill be eliminated. We further understand that you are going to offer for the record a copy of the Ohio regulation known as Q–3 which will be presented as evidence that most open-end trusts are already operating under rules and regulations in various States.

We, as a corporation having 2,865 stockholders, wholeheartedly support the thoughts you have on this subject and hope that you will stress the fact that if legislation is finally adopted, it will be drawn somewhat along the lines of Q–3 under a separate title. We urge this, for as a practical matter we feel such regulation adequately safeguards stockholders and yet is the type of legislation which does not disrupt our whole method of doing business.

We ask that you present our thoughts on this matter to the committee.

Boston Fund, Inc.,
Robert L. Osgood, *Vice President.*

Century Shares Trust,
Boston, April 15, 1940.

Richard N. Taliaferro, Esq.,
c/o Fidelity Fund, Inc., Boston, Mass.

Dear Mr. Taliaferro: You have asked us whether we feel it would be wise for our trust and for the open-ended management investment companies in general to have substituted for the investment company bill now before Congress a bill along the lines of Ohio's regulation Q–3. We are of the opinion that the Q–3 type of regulation with some clarification is preferable to Senate bill 3580. Q–3, in some respects, gives security holders better protection than the Senate bill and has great advantage to the industry and so to the shareholders in avoiding a multiplicity of laws with differing provisions which managers of investment companies must keep in mind and follow.

As one of the pure Massachusetts trusts whose shareholders, of course, have no vote, although the trust instrument can be amended in certain respects only with the written consent of the holders of a majority of the shares, we feel that the paragraphs of Q–3 calling for shareholders vote, that is, paragraphs 6, 18, and 19, should not apply to pure trusts to an extent which would endanger their legal status as a pure trust or force them to incur expenses which as pure trusts they now avoid.

Very truly yours,

Century Shares Trust,
———— *Secretary.*

Eaton & Howard, Inc.,
April 17, 1940.

Richard Taliaferro, Esq.,
Boston, Mass.

Dear Sir: We understand that you are making to the Senate subcommittee, which is considering Senate bill 3580, a statement to the effect that a number of investment companies or trusts located in Boston, whose shares are qualified for sale in the State of Ohio under the so-called Regulation Q–3 of the Ohio Securities Division, find that regulation practical and workable.

We are qualified under that regulation and feel that it represents a careful attempt by the Ohio Securities Division to protect investors in that State without involving the filing of voluminous reports and without undue interference with the management of the qualifying company. At the same time we believe such a regulation will prevent, as to companies complying, the occurrence of the abuses at which the Federal Investment Co. Act is aimed.

While there are a few points in this regulation with which we are not in sympathy and which we would be glad to explain in detail, we are glad to say that we endorse the regulation in principle and believe it might well be considered by the United States Senate committee as a method of approach for regulating open-end investment companies.

Very truly yours,

Eaton & Howard, Inc.,
By Charles F. Eaton, Jr.,
President.

GENERAL INVESTORS TRUST,
Boston, Mass., April 16, 1940.

MR. RICHARD TALIAFERO,
c/o WILLIAM W. MACKALL, JR.,
Woodward Building, Washington, D. C.

DEAR MR. TALIAFERO: The Trustees of General Investors Trust have read with a great deal of interest a copy of the statement which, we understand, you are to make at the hearings before the Senate Banking and Finance Committee, now being held in Washington, relative to proposed investment trust legislation.

We wish to take this opportunity to assure you that we are thoroughly in accord with the principles, which you outline in your statement, in which you refer to the workings of the Ohio regulations relative to investment trusts known as Q-3. We are qualified in Ohio under these regulations.

We feel that your suggestion is constructive. The present Senate bill, S. 3580, would, in our opinion, work tremendous and unnecessary hardship on our stockholders and would greatly impede the proper and sound management of our fund.

Very truly yours,

JOHN H. SHERBURNE,
For the Trustees.

HILL, BARLOW, GOODALE & WISWALL,
Boston, Mass., April 16, 1940.

MR. RICHARD N. TALIAFERRO,
c/o MR. WILLIAM W. MACKALL, Jr.
Woodward Building, Washington, D. C.

DEAR MR. TALIAFERRO: As counsel for New England fund and as one of its trustees, I have read a copy of the statement which you propose to make before the congressional committee which is considering legislation to regulate investment companies.

There has been no opportunity since reading your proposed statement for me to submit a copy to any meeting of our trustees for formal action, but I am convinced from informal conversation with some of my cotrustees, that they are in entire agreement with your recommendations.

To be more specific I understand these recommendations to be in substance—

First. That separate regulatory provisions should be applied to the five types of investment companies mentioned by you; the regulations applicable to each type to be appropriate to investment companies of that specific type.

Second. That in the regulation of investment companies of the open-end management type, of which New England fund is an example, the experience of State regulatory bodies which have had long experience in actual regulation, should be drawn on by the committee. I consider the Ohio regulations, known as Q-3 to be a valuable model for the regulation of open-end investment companies in a manner which, while stringent, is nevertheless consistent with practical operation of a sound and honestly managed investment company.

I may add, for purposes of identification, that New England fund is a Massachusetts common law trust organized in 1931 as Mutual American Securities Trust. It has, in round figures, $3,300,000 in assets with no outstanding bonds or other liabilities other than routine, current operating expenses of negligible amount, accrued during the current month. It has outstanding 257,763 shares held by some 1,700 or more widely scattered holders.

Let me add further that the trustees of New England fund do not object but, rather, welcome the regulation of investment companies, including reasonable limitations of size. They ask only that regulations be intelligently and carefully framed in such a manner as to accomplish the elimination of abuses without imposing on sound and well-managed companies needless and expensive requirements which would handicap legitimate operations and which, by their complexity and expense would perhaps eliminate all but the larger companies.

Very truly yours,

FRANCIS G. GOODALE.

Senator WAGNER (chairman of the subcommittee). Secretary Adams, please.

STATEMENT OF HON. CHARLES F. ADAMS, BOSTON, MASS.

Senator WAGNER. Mr. Secretary, we are glad that you are here.

Mr. ADAMS. Senator Wagner, and members of the committee: I appear here as a citizen whose life work has largely been devoted to the management of other people's property, in a fiduciary capacity. In addition to acting as trustee under a good many investment trusts, I served for 30 years as treasurer of Harvard College. In that capacity, I was the chief financial officer of the college and a member of the governing board of seven. Subject to the directions of that board, I had charge of the funds of the university. Since 1894, I have been one of the trustees of Boston Personal Property Trust, probably the oldest investment trust in this country. It is a closed trust, and its affairs are conducted by a board of five trustees who are not elected by the shareholders, vacancies being filled by the remaining trustees. I am also a director or trustee of several other investment trusts and corporations, both open-end and closed, and a member of the advisory board of Massachusetts Investors Trust, which is, I think, the largest and oldest of the open-end companies. During this period, I have served on the boards of directors of a good many other companies, such as the American Telephone & Telegraph Co., the Boston Edison Co., Eastern Gas & Fuel Associates, and the General Electric Co., and I am chairman of the board of directors of the State Street Trust Co. of Boston. During these years it has frequently and inevitably come about that funds, for the management of which I was jointly responsible with others, have been invested in the securities of companies of which I am a director and from time to time, for one reason or another, such securities have been sold.

Such being my experience and such being the activities in which I am interested, I am naturally concerned with any proposed legislation which may affect the best way of handling the problems before us, in the public interest. I have not read this bill through. It is long and complicated. I think I have a pretty good general idea of what it seeks to accomplish and how it seeks to accomplish it. I have experience which may be of value to you and opinions which I should be glad to express in response to any particular questions which might be asked me by members of your committee; but I do not propose, nor am I prepared, to offer specific comments on most of the details of the bill as written.

There is, however, one section of the bill which has been brought to my particular attention, and that is section 10, which undertakes to do away with conflicts of interest on the part of persons connected in various capacities with the management of investment companies. Forty-six years of experience have proved to me that such conflicts are rare and unimportant and that the injury to the best conduct of industry by this section 10 is very important. The particular part of that section of which I want to speak is subsection (e) found on page 25 of the bill, which would make it unlawful for any director or officer of an investment company to serve or act as director or officer of another company, any security of which is owned by the investment company if, first, the investment company owns less than 5 percent of the voting securities of the issuing company, or, second, the director

or officer in question is an investment banker or broker or affiliated with an investment banker or broker.

I am not an investment banker or broker and never have been, so I do not propose to go into that particular phase of it. I am, however, a director of a number of companies, some of them very large companies, securities of which are owned by the investment companies, or other funds of which I am a trustee or director, and I have found myself in that position in a great many instances over a considerable number of years. I am distinctly one of the culprits against whom this particular provision of the bill is directed. So I submit myself to your questioning because you and I want to know whether or not it is better for this practice to continue.

It is easy to state a hypothetical case in which one placed in the position which I have described might be embarrassed or given an opportunity for improper action, and it may be that actual cases can be cited in which it would have been better for all concerned if the so-called conflict of interest had not existed. All I can say is that in my many years of experience, I have never found the position embarrassing or improper and I do not think that any trust or corporation with which I have been connected has ever suffered from the fact that I was in that position. I am confident that the relation has on the whole been in the public interest. I therefore feel very strongly that the possibility of any harm arising out of this situation is so remote that it does not in any way justify the laying down of such a rule as this, which I believe would tend to injure the best interests of investors to an extent far greater than any good which it could possibly do.

Please remember that I should not be in any of these positions unless my reputation gave confidence to stockholders, unless they wanted me to serve them. Moreover, the experience which I have accumulated, both on boards of industrial and other companies and on boards whose principal duty is the investment of money, has doubtless made me more useful on other boards. Perhaps I should apologize for speaking so much in the first person, but I present myself merely as an exhibit. There are plenty of other men in the same situation, whose value to the funds which they help to manage and to the companies on whose boards they serve is doubtless greater than mine. I feel that the provision of the proposed bill which I have been discussing would disrupt a great many valuable existing relationships and prevent a great many valuable new relationships, to the detriment of the investment public. May I give an example of this injury?

The difficulty, and essential importance to industry and our country, of securing directors of experience, character, and intelligence is great. The importance is obvious and essential.

Where can you find them? You generally have to look among stockholders. Many do not want to serve. The responsibility is great, the risk is considerable, the pay is small.

It is not desirable to use the office boy or his equivalent, for obvious reasons.

It is not desirable to hire at considerable salaries directors who have no interest. They tend to justify their salaries by bossing a good executive until initiative is gone and each director is a focus for the discontented. You would not think well of a President of the United States bossed by a Cabinet who controlled him.

Without more detail, the most important single job of a director is to watch for signs of failure, mentally or morally, of the chief executive and to bring about a change when necessary.

Then wisdom and experience and position are necessary, backed by holdings of stock. Do not rob industry of such essential men, to avoid a rare and fancied risk which can readily be cured by barring interlocking control.

I also understand that section 9 of the bill requires every person who acts as an officer or director of a management investment company to be registered with the S. E. C. Apparently, the purpose of this is to permit the S. E. C. to weed out those who have criminal records or have been enjoined from carrying on certain types of financial business. That may be all right, and I have no particular objection to being registered; but when I read that my application

shall contain such information and documents, in such form and such detail, as to such person and affiliated persons of such person, as the Commission may by rules and regulations prescribe as necessary or appropriate to effect the purposes of this title

(p. 21), I cannot help wondering just how far the Commission is going to think it necessary or appropriate to go in requiring information and documents not only as to my own personal affairs but as to the affairs of my partners, if I had any, and other companies in which I may have a 5-percent interest or in which I may be a director. Perhaps the information required may be comparatively simple and easy to furnish, but certainly the power granted to the Commission is so broad that if it were to be employed unreasonably it might be a very serious deterrent to persons of the utmost integrity and ability from accepting positions as trustees or directors of investment companies. I see no good reason for the delegation of such authority as this to the S. E. C. if the only purpose is to enable them to eliminate those whose public records brand them as grossly unfit.

Then, again, it has been pointed out to me that section 30 (e), on page 69, requires all directors and officers of an investment company to report quarterly to the board of directors their own transactions in securities in which the company had any transactions during the quarter. I am told that the purpose of this is to prevent officers and directors from taking unfair advantage of their beneficiaries by acting on information which may come to them in advance of such action being taken by the trust which they are supposed to be serving. Well, I suppose that there are or may be men serving as officers or directors of trusts who would act in this way, although I have never had the misfortune to serve on investment-company boards with men of that type. The point, to my mind, is whether it is wise to make a rule which assumes that men would so act unless deterred by the necessity of disclosing their actions to their associates. I think it would be very distasteful to many men of the highest type to be required to make such disclosures. It would tend to turn a directors' meeting into a discussion of one another's private affairs. Moreover, as the bill reads, it is not clear that it does not require the disclosure of transactions carried on by directors in a fiduciary capacity. I certainly do not feel that I should be asked to recite to the directors or trustees of one investment company the transactions that I may have participated in for another company or for a testamentary trust of which I may be a trustee. I do not think it would be proper for

me to make such disclosures. This seems to be one of those features, of which I fear there are many in this bill, by which—in order to head off improbable abuses—burdensome and distasteful regulations are imposed upon men who are trying to give of their best to those whom they are appointed to serve. I think such regulations tend to deter the best men from accepting those fiduciary positions and I do not believe that the good which such regulations might possibly do in some instances is sufficient to outweigh the harm which this sort of regulation is going to do to the character of investment-trust management.

Senator WAGNER (chairman of the subcommittee). Thank you very much, Mr. Secretary.

Mr. ADAMS. Are there any questions you would like me to answer?

Senator WAGNER. Well, I think you have stated your views.

Mr. ADAMS. Thank you.

Senator WAGNER (chairman of the subcommittee). Dr. Sprague, please.

STATEMENT OF OLIVER M. W. SPRAGUE, BOSTON, MASS.

Senator WAGNER. Dr. Sprague, we are delighted to hear from you regarding the pending legislation.

Mr. SPRAGUE. Thank you, Senator.

My name is Oliver M. W. Sprague. I am a member of the advisory board of the Massachusetts Investors Trust; and I shall take but a few moments of your time. I merely wish to amplify and qualify certain evidence which I gave in 1936 that had to do with the size of investment trusts. In my evidence I was rather exploring the subject of investing trusts and indicating some of the complexities of handling trusts. At that time I was rather impressed by the rather rapid growth of the Massachusetts Investors Trust, and various other trusts; for I think that in 1935 and 1936 the growth was more rapid that at any time except in the period just before the collapse in 1929.

I was impressed a little at that time with the possible difficulties that might present themselves in connection with the rapid inflow of funds. That is the sort of difficulty that presents itself in the case of any business when it experiences an unexpected, rapid growth in its business. I think that some of the machine tool companies are in that position at the present time.

I had no idea that the suggestion would be made the basis for legislation. It was simply a business problem.

Well, Senator, in reflecting upon our experience since that time, I am unable to think of any period during which our judgment in the matter of investing seems to have been appreciably and undesirably affected by the rather rapid inflow of funds at that time. Since 1937 there has been no such growth.

It does not, then, seem to me that the contingency of rapid growth of a trust requires legislation; and the passage of this bill would not provide legislation affecting rapid growth. However, I think that the observations which I made about rapid growth are in part responsible for the provision limiting size.

Now, Senator, I was inclined some years ago to think that size might be a disadvantage in making the best possible investments.

I do not think so now, after 4 years of further experience. The reason I was inclined to think so then, I rather think, was this: that I was attaching more importance to trading profits, to moving out into different securities, than I would do now. After 4 years of further experience it is my opinion that income considerations are of overshadowing importance in the proper conduct of an investment trust, particularly one of any considerable size; and I rather think that a large investment trust is pretty certainly more influenced by pure income considerations than a smaller trust need be.

We change our securities from time to time; but my impression is that we change them because we come to think that the prospects of a particular industry are not so good as they seemed formerly or because we are dissatisfied with the management of a particular company or possibly because we think that the price of a given security has reached pretty dizzy heights.

However, with a company having assets of over a hundred million dollars, I think we are likely to feel that there is not much in it for us—the mere play of the market, meeting various mild fluctuations in the stock list.

So, Mr. Chairman, if you want highly conservative management of investment trusts, I think you make a mistake if you attempt to provide for a multitude of trusts of small size, with a very large number of separate management groups.

That, I think, is about all that I have in mind to say, in amplification of what I said about the size of companies. It is perhaps simply repetitious to say that investment is not a simple matter, that the number of people available for the satisfactory handling of investments is not indefinitely large; and so I should concur with what Mr. Adams said a moment ago: that measures calculated to eliminate a very considerable number of competent people from the service of investment trusts would not seem to me to promise very much for the investor, even though here and there, as an incidental result, you might eliminate some instances of abuse of power and relationship.

Senator, I think that covers all that I had in mind to say.

Senator Wagner. Thank you.

Doctor, undoubtedly you did read about some of the testimony presented here, showing some very tragic abuses and improper practices. Perhaps the question almost answers itself; but if there is some regulation that can prevent such practices and can prevent the recurrence of those abuses which resulted in large losses to small investors, and without in any way interfering with the responsible and legitimate operations of investment trusts, do you not agree that such steps certainly ought to be taken?

Mr. Sprague. Oh, I entirely agree.

Senator Wagner. Yes.

Mr. Sprague. Such matters as the pyramiding or complicated security arrangements seem to me to be always inadvisable, whether they be in investment trusts or in the match business.

Senator Wagner. Yes.

You were talking about responsible directors and managers. Of course, I concur in everything you say about that. However, I am sure you remember that in some of these instances of manipulations of trusts or purchase of trusts—even without any funds—there were substitutions of directors arranged whereby mere dummies were put

on the board of directors, under circumstances where these dummy directors would do what the other directors wanted to be done. This gave rise to a situation where large losses resulted, as of course you know. All that happened because there was no regulation at all to prevent it; and I understand that in one instance one of the dummy directors was just a bartender, who was put in there as a director because he would do what the other directors wanted done. Very large losses resulted from such situations, as you know.

Mr. SPRAGUE. Yes, quite.

Senator WAGNER. Certainly it is our duty to do what we can to prevent the recurrence of a situation of that kind or to make it as difficult as possible for such a state of affairs again to exist.

Mr. SPRAGUE. I quite agree; but I should think—and I am not a lawyer—that the measure included, in order to accomplish this, in its present form threatens to eliminate a large number of serviceable people.

Senator WAGNER. Of course, we do not want to do that; and, as I say, we want to find a means of preventing those abuses without interfering with the legitimate operations.

Mr. SPRAGUE. We now have more publicity than in the case of a great many of those instances to which you refer.

Senator WAGNER. Yes.

Mr. SPRAGUE. But I am not implying that there should be no regulation. I am rather concentrating on the mere question of size.

Senator WAGNER. Yes, I understand that.

Mr. SPRAGUE. And then I happened to drift into this matter of management.

Senator WAGNER. Yes.

Mr. SPRAGUE. It is suggested to me that I criticized small trusts, in what I said a moment ago. I did not wish to criticize them. I merely wished to say that if the interest of the investor is one of making trading profits or if he expects trading profits to be made, then I think he would better invest in a smaller-sized trust, because I do not think the large kind is suitable for that particular sort of profit; and, as one of the witnesses already said here, this morning, there are different objectives of different groups of investors. I might personally be interested in a highly conservative investment trust but also might be quite willing to put a few dollars into one that I knew was seeking to make trading profits.

I do not say that the small trust will be speculative; I am simply saying that I think the large ones almost inevitably must be conservative because they have necessarily large blocks of securities which make it altogether impracticable to make profits from playing the market.

Senator WAGNER. There is one other question I was going to ask you, that I had forgotten.

Mr. SPRAGUE. Yes.

Senator WAGNER. As a general proposition, I am asking this only because I know you are a scholar on all these subjects and a recognized authority: You agree with me that investment trusts have a real and very important place in our economic life? Don't you think so?

I mean that I should think more and more people are coming to this idea of investing in diversified securities—particularly the small investor who is not in a position to inform himself as to what particu-

lar investment would be wise, or has not enough money to spread it around by the purchase of different securities?

Mr. SPRAGUE. Yes.

Senator WAGNER. It seems to me that an investment trust would be a very attractive form of investment, for that particular individual—and there are very many of them?

Mr. SPRAGUE. Yes. That is especially true as regards those who are seeking safety.

However, Senator, there is another avenue for the investment trust, almost equally important and perhaps just now more important: We do need sources of supplies of funds available for undertakings involving a considerable measure of risk.

Senator WAGNER. Yes.

Mr. SPRAGUE. It is not desirable that we should all invest in purely gilt-edged securities; and I look for a development of some investment trusts directed toward furnishing equity capital to growing undertakings, and not necessarily those of the very largest size; and I should be inclined to think, Senator, that the operations of this bill would rather work against that growth, which has not been as great as I think it should be, of enterprising investment trusts.

Senator WAGNER. I do not disagree with you in that regard, except that it seems to me that ought to be a different type of investment trust. In other words, it seems to me that when I am putting my money into that type of investment trust, I ought to know that I am supplying risk money or venture money.

Mr. SPRAGUE. Quite so.

Senator WAGNER. The important point there is that I ought to know, by the representations made, what type of trust I am investing in.

Mr. SPRAGUE. Yes.

Senator WAGNER. I agree with you that we need a good deal of this risk money or venture money and that there is not enough of it coming out now. We all understand that.

However, I think you and I do not differ upon the proposition that that is a somewhat different kind of investment from the diversified investment, where it deals primarily in safe securities with pretty sure returns—as sure as we can make them—rather than dealing in a venture.

Mr. SPRAGUE. Well, what would you think of this one, Senator: That half a dozen investment trusts would pool, say, 5 or 10 percent of their total funds for a cooperative venture, of an investment type—and, of course, the public's being fully informed, and their prospectus stating it, and so on?

That has sometimes seemed to me to be a possibility.

Senator WAGNER. Yes.

Mr. SPRAGUE. Because it requires far more research than many of, at least, the smaller trusts require, to undertake intelligently to supervise such investments; and I am fairly certain that in such a development it would probably be desirable that the cooperative trust fund, that I speak of, have representatives on the boards of the companies that they assist.

That is simply one possibility; and, of course, it would not be possible under this bill, with this elimination of any relationship on any considerable scale between portfolio and directors.

Senator WAGNER. Yes. Well, Dr. Sprague, I think we need both types, don't you?

Mr. SPRAGUE. I do.

Senator WAGNER. But I think the important thing is that the individual—and I have said this so often that I shall not say it any more—should know what type of investment he is making.

Mr. SPRAGUE. Yes.

Senator WAGNER. I think the individual investor should know whether he is taking a mere chance—perhaps with large profits in prospect, and perhaps a total loss—or whether he is putting his money in the other type of investment, which is the same, safe type of investment that we have been hearing about today.

Thank you very much, Doctor.

Mr. SPRAGUE. Thank you, Senator.

Senator WAGNER. We shall recess at this point until 2:30 p. m.

(Thereupon, at 12:15 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTER RECESS

The subcommittee resumed at 2:30 p. m., on the expiration of the recess.

Senator HUGHES (presiding). The subcommittee will resume its hearing. I believe the next witness is Mr. Eberstadt.

The chairman of the subcommittee regrets that he is unavoidably detained on other business and must be absent the balance of the day. Of course, I may not be very successful as presiding officer, and certainly cannot proceed as well as he could, or Senator Downey could, but I wondered if I might make a suggestion about the hearings: I have not consulted with the other members of the subcommittee about this, but I have attended a great many of these hearings, and, of course, all of you gentlemen must realize that the time of the members of the subcommittee is limited, because we have to act on a good many committees of the Senate. We want everybody to have an opportunity to be heard, but might I ask if you, in presenting your evidence, would be as concrete as possible?

Mr. EBERSTADT. Gladly so.

Senator HUGHES. We take it for granted that you are opposed to the bill, or at least parts of the bill.

Mr. EBERSTADT. I do not know that you are right in taking that position.

Senator HUGHES. I mean, you are opposed to parts of the bill.

Mr. EBERSTADT. Yes, to parts of the bill.

Senator HUGHES. If you would as best you can state your objections to the parts of the bill to which you do object, it would be appreciated. I have been inclined to feel that some of the witnesses have rambled all over the field of investment securities, and often have taken a lot of time and space in the record that did not seem really necessary. I want you in your evidence to cover so far as you see fit to do so what you wish to cover, but I am making that suggestion, and of course you can do as you like.

Mr. EBERSTADT. Senator Hughes, I want to comply with your suggestion. I am a guest of the subcommittee, and if you feel that in any way I am rambling over the field, you will please stop me. That is the last thing I want to do.

Senator HUGHES. I think we have all felt more or less that we have taken more time than we should have.

Senator DOWNEY. You have a prepared statement, Mr. Eberstadt?

Mr. EBERSTADT. Yes.

Senator DOWNEY. I take it he could not very well depart from that prepared statement and properly present what he has to say.

Senator HUGHES. Well, I do not know about that. Everybody is doubtless familiar with what is in the statement, and perhaps he could leave his statement here for our record, taking up at this time such portions of it as he wishes to emphasize. The portion that he does not read can be printed in the record of our hearings.

Mr. EBERSTADT. With your permission I will start out with my statement, and at your suggestion will be glad to leave out anything that you think is not relevant to the inquiry, although I hope I have not anything of the kind in my statement. You will realize I am sure that this is something in which we are deeply interested. However, I may put in something that you think is not necessary, and if so please stop me.

Senator HUGHES. We will not stop you. You may go as far as you think necessary.

Mr. EBERSTADT. I have taken the warning, and certainly take it in good spirit, and will have it in mind in presenting my statement, Mr. Chairman.

Senator DOWNEY. Mr. Chairman, before the witness proceeds with his statement might I have a word to say?

Senator HUGHES (presiding). Certainly, Senator Downey.

Senator DOWNEY. I have a letter from Henry S. McKee, president, Pacific Southern Investors, Inc., and American Capital Corporation, of Los Angeles. The letter is quite brief and I would like to read it to the presiding officer and Governor Herring:

> My associates and I here will immensely appreciate it if you will read the attached statement and see that it goes before your committee in the investment trust matter and becomes part of the record of the hearing.
>
> It has two purposes:
>
> 1. To prevent a shocking injustice.
> 2. To protect the committee from acting upon misinformation.
>
> If you can do this it will save us from traveling from California to Washington and back to present it.
>
> We would also like to state, for the record, in lieu of personal appearance, that we have read the testimony of Mr. Bunker and, out of our experience of 13 years in this business, concur in it fully.

From what I know in a general way Mr. McKee is a highly reputable and able businessman, and his organizations are very high class. Unfortunately it appears that in Mr. Schenker's testimony—and I have already consulted with him about it, Mr. Chairman—there is a marked ambiguity. Mr. Schenker was speaking generally of certain other investment corporations. His remarks were not meant to apply to this particular corporation, but the way the record reads one would clearly deduce that it does.

I will not read this statement, Mr. Chairman, and it may be placed in the record, but it will clarify the situation. Furthermore, Mr. Schenker has himself suggested that he would like to make some statement about the matter at this time.

Senator HUGHES (presiding). Without objection the statement will be made a part of the record at this point.

(The statement submitted by Senator Downey is as follows:)

STATEMENT REGARDING A CHART HEADED "AMERICAN CAPITAL GROUP;" AND REGARDING THE TESTIMONY THEREON OF MR. SCHENKER ON APRIL 9TH. BY HENRY S. MCKEE, PRESIDENT, AMERICAN CAPITAL CORPORATION, PRESIDENT, PACIFIC SOUTHERN INVESTORS, INC.

In connection with the chart headed "American Capital Corporation," there appeared a statement by Mr. Schenker which is untrue and misleading if applied to these companies.

Regarding this chart, Senator Wagner asked:

"Can you tell us the reasons for all of these organizations? You investigated this matter, did you not?" Mr. Schenker replied:

"Oh, certainly. The reason is that by doing this you can solidify your control of the particular situation. They would control the one company. And it has not been unusual, as we have shown, that they buy control, in the first instance, over that borrowed money by which they reimburse themselves for the sale of dubious securities, and they buy management stock. There is one case where $30,000,000 of the public's money was raised and the management stock was sold, for 50 cents a share, for $200,000.

"In that particular instance the management sold its management stock for a very substantial amount, and control was turned over to somebody else. Then they get control over part of the management stock, and take the investment trust funds and buy the common stocks of other companies which have money of the senior security holders, and in that way they can build up this very substantial pool."

It would appear from careful reading that Mr. Schenker was generalizing rather than referring specifically to our companies and yet the nature of the question, with the chart before the committee, was such that Mr. Schenker's answers contain an insinuation with rerpect to these companies that is wholly misleading.

The truth about the matter is as follows:

1. In 1927 in Los Angeles five men, among the best known and most highly respected citizens in the community, organized Pacific Investing Corporation.

They acted upon every sound principle of law, correct business ethics, fairness, justice, and honor. They were the directors. The company was successful far beyond their expectations.

2. A year later, in response to a strong demand upon them from substantial and intelligent investors, the same men, with two additions, organized American Capital Corporation.

This also was gratifyingly successful.

These two corporations had practically the same directors and were almost exactly alike. It was therefore later decided to merge them into one, for simplicity and economy.

The first step was that American Capital offered to issue its common stock in exchange for the common stock of Pacific Investing Corporation, and thus acquired most of it. The insinuation that the directors, who were virtually the same in both companies, were scheming for one to control the other is thus seen to be pure nonsense. The completion of the intended merger was prevented by the events of the ensuing long depression.

3. In 1932 Pacific Investing Corporation acquired the assets of Southern Bond & Share Corporation, of Birmingham, Ala., by a merger after long and fair negotiations, with almost unanimous approval of all stockholders of both companies. The resulting merged company was called Pacific Southern Investors, Inc.

Its board of directors became practically a merger of the personnel of the boards of the two merged companies. A large part of its common stock of course still continued to be owned by American Capital Corporation.

4. A couple of years later Pacific Southern Investors, Inc., bought about half of the stock of The Investment Company of America an investment company located in Detroit, of sound quality and managed by men of the highest ability and character. This was done in the belief that it would be a sound and profitable investment, which it has since proved to be.

5. But it happened that prior to the making of this investment the Investment Company of America (none of the officers or trustees of which had been a director of Pacific Investment Corporation and only one of whom had been a director of Southern Bond & Share Corporation) had bought, purely as a good investment (which it proved to be), a rather small amount of the stock of American Capital Corporation.

6. By that innocent and wholly proper and desirable course of events, it thus came about that American Capital could control Pacific Southern; Pacific Southern could control Investment Company of America (had they wished to do so, which they did not) and Investment Company of America owned some stock (by no means control) of American Capital Corporation.

7. But we realized that such intercorporate relationships, even though properly arrived at as in this instance, are always open to misunderstanding and criticism; so we at once (in 1934) began a series of steps to separate these companies from one another.

8. As the first of these steps, American Capital Corporation promptly disposed of all of the securities of Pacific Southern Investors, Inc., which it owned. Instead of selling this potential control in the nefarious manner which the Securities and Exchange Commission seems to consider customary in this industry, the American Capital Corporation gave its own stockholders the prior right to buy from it the Pacific Southern securities, which the stockholders did.

9. The next step was for Pacific Southern Investors, Inc., to dispose of its investment in the Investment Company of America, and it has been in the course of doing so steadily for many months. Again, it is not selling this potentially controlling block of shares to someone in the way the Securities and Exchange Commission insinuates. It is selling them gradually on the market, in the usual way, to many investors at a fair and just price under Securities and Exchange Commission registration.

Conclusion: The companies here mentioned have, from the beginning, been conducted by honorable men with the most scrupulous regard for law, business propriety, high ethical standards, and the fullest rights of stockholders. Except for the fact that they did not foresee the full ruinous severity of the financial convulsion of 1929 to 1932, their record of performance has been highly creditable and excellent, of which abundant public proofs exist.

We resent deeply the injuries done us by reason of the false implications to be drawn from Mr. Schenker's testimony as reported in the transcript of the hearing and respectfully urge that the foregoing statement be presented to the members of your committee and of the Congress as fully and forcibly as is possible.

Senator Hughes (presiding). We will be glad to hear Mr. Schenker.

Mr. Schenker. Mr. Chairman, I am inclined to agree with Mr. McKee that the present state of the record may be susceptible of the inference that my general discussion with respect to the practice of acquiring control of investment trusts, and the particular illustration I gave, might refer to his company. That is not the fact.

Our relations with the American Capital Corporation have been of the highest cooperative standing, as they have given us all the information we requested. The fact of the matter is that the particular passage he refers to was in response to a general question by Senator Wagner: Why do they have one investment trust buy control of another, as exemplified in the various other cases which I discussed in some detail before I mentioned American Capital Corporation?

I think Mr. McKee's feeling in the matter is entirely justified. I think the record ought to be unequivocal that the particular portion of the discussion he quotes was not applicable to any of his companies.

Senator Hughes (presiding). I thank you, Mr. Schenker. We will now hear Mr. Eberstadt.

STATEMENT OF FERDINAND EBERSTADT, PRESIDENT OF F. EBERSTADT & CO. INVESTMENT BANKERS, 39 BROADWAY, NEW YORK CITY

Mr. Eberstadt. My name is Ferdinand Eberstadt. I am the president of F. Eberstadt & Co., investment bankers, specializing in the underwriting and distribution of securities of medium-size companies. I am also president of Chemical Fund, which is an open-end

investment company, whose portfolio is confined to securities of seasoned companies in the chemical and chemical-process fields.

While the name Chemical Fund appears to be limited to a special field, under the definitions of the bill it would probably and could properly be treated as an open-end diversified investment company, in view of the wide variety of products and processes embraced within the terms chemical and chemical process, which are said to include over 20 percent of the manufacturing business of this country.

It is a newcomer and one of the youngest companies in the investment trust field, having been organized something under 2 years ago with an original investment of $100,000 made privately by ourselves and some friends. Its net assets currently are in excess of $8,500,000. It has over 780,000 shares outstanding, all common stock, held by approximately 4,500 stockholders throughout the country, whose holdings average about 170 shares, or slightly under $2,000, each. Originally offered to the public at $10.81, the shares are now selling at a substantial advance over this figure and recently reached their highest price.

So far as I know Chemical Fund has never been subjected to criticism or complaint from any of its shareholders, the S. E. C., any "Blue sky" law commission, or any security dealer.

Our attitude toward this bill is expressed in an excerpt from our current annual report to stockholders, as follows:

> While the present draft of the bill in certain respects is deemed objectionable and it will be the policy of your company to oppose the passage of the measure in its present form, on the other hand, your company favors and will cooperate toward the passage of a bill with reasonable provisions.

We would welcome legislation which would not only drive out crooks and embezzlers from the business, but which would generally establish a high standard of business ethics and conduct.

My opposition to the bill is not solely because of any particular effects which it might have on Chemical Fund. So far as I can make out, although I don't feel sure because of the length, complexity, and vagueness of the bill, Chemical Fund would be affected by the definite and mandatory provisions of the bill only in two respects. These, however, are matters of considerable importance.

In the first place, we would lose one, and possibly two, of our valuable outside independent directors. In the second place, we would have to make an inconvenient, wholly artificial, and perhaps expensive, rearrangement with respect to mechanics of management.

When we decided to organize an investment company in the chemical field, we made a study of over 50 different investment trusts of various forms and types, and came to the conclusion that the open-end investment company with redeemable shares, which, in order to qualify as a mutual company must restrict its investments to not more than 5 percent of its assets in any one company and own not more than 10 percent of any one company, was the form best adapted for the purpose, as the provisions and restrictions of such a trust seemed to us to afford to its stockholders the maximum of protection against its use as a vehicle for purposes or objectives in conflict with their best interests.

In connection with the preparation of our set-up, I would like again to express appreciation to Mr. Schenker and his associates for the generous manner in which they put their time and advice at our disposal.

But in spite of the fact that Chemical Fund seems to be affected only to the limited extent that I have indicated above by the clear and definite provisions of the bill, the gist of my position is that I recommend against any bill at this time and against the bill in its present form at any time.

My objection to any bill at this time is based upon my feeling that investment trusts constitute such an enormous reservoir of potentially productive capital, so closely related to the capital market generally, that they should not be treated separately and apart from the subject of capital investment generally.

Paragraph 4 of section 1 of the bill itself recognizes this fact in stating that investment companies

are media for the investment * * * of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets.

There has probably never been a time in the history of this or any other country when there has been so much capital available for investment, nor has there in our history, in my opinion, ever been a time of greater need and opportunity for investment. But one of the important obstacles in the way of bringing these two elements together is the fact that the two fundamental Federal securities laws, namely, the acts of 1933 and 1934, have the same serious defects of detail, not of principle, that are so evident in the bill which is before your committee for consideration.

We can only maintain and improve our standard of living through increasing wages and salaries, reducing manufacturing costs, and improving the quality and lowering the price of the product to the consumer. There is no real inconsistency between rising wages and decreasing costs and prices. This can and must be achieved by more efficient installations resulting from research and acquired through investment of capital. In the same way and from like sources new industry must be started and nurtured. By putting at the disposal of labor and management more up-to-date and more efficient methods and installations, each can earn a larger return and together produce a better product at a lower cost.

Either the free flow of capital, which is present in abundance, must be restored or this deficiency will have to be supplied by Government, or the standard of living cannot be maintained.

We are not one of the so-called large-issue houses. We specialize in the issues of smaller companies and are therefore, I think, qualified to speak of the difficulties and burdens involved in raising capital for these enterprises under existing statutes and regulations. Neither with respect to the securities acts nor with respect to the "blue sky" laws do I criticize the fundamental purposes and provisions. On the contrary I am strongly in favor of these. I would not repeal the Securities Act in toto were it in my power to do so, a view which I think is shared by most of the investment dealers throughout the United States, nor am I talking of such subjects as "competitive bidding" or "arm's length bargaining."

I regard these as incidental to the main question. But I am opposed to the almost insuperable barriers of red tape, irrelevant detail, reports, paper work, petty obstacles, vague and involved rules and regulations, which render it expensive, time consuming, and unspeakably difficult to do business in our field, where I think it is even more true than with respect to the so-called large companies.

At this point I was going to furnish an example of this, but in view of your remarks, Mr. Chairman, perhaps I will pass over it.

Senator DOWNEY. Mr. Chairman, I want to hear everything the witness has to offer.

Senator HERRING. Oh, yes. I should go right ahead, Mr. Eberstadt.

Mr. EBERSTADT. Well, I would just like to say that I recently received a letter from the Securities and Exchange Commission, at Washington, of the type mentioned and which I think is entirely immaterial to truth in securities and fair dealing in securities, but is a sample of the inexhaustible burden of detail under which we are laboring. I will read a part of the letter, and I think a part will be enough, but if you want me to go ahead and finish it I will do that, too. The letter is addressed to F. Eberstadt & Co., 39 Broadway, New York City, and is from the Securities and Exchange Commission:

> After considering the explanation contained in your letter with respect to the reporting of the sales of the above-named securities reserved by you for sale otherwise than as syndicate manager, I find that if the information shown in your reports on Form X–17A–3 for December 7, 1939, is correct, your reports on Form X–17A–1 for the same date were filed incorrectly. For example, in your report on Form X–17A–3 for December 7, 1939, with respect to the preferred stock, you showed in the answer to item 3 (a) (i), that you reserved 650 shares of that stock for sale otherwise than as syndicate manager, and that Hawley Huller & Co. reserved 10,000 shares of that stock for sale otherwise than through the syndicate manager. Moreover, in the answer to item 3 (c) (ii) you showed that prior to the close of business on December 7, you allotted 9,350 shares of the stock to persons invited to become members of a selling group. Consequently, pursuant to subparagraph (a) (3) of rule X–17A–2, you should have filed a report on Form X–17A–1 for December 7—[Laughter.]

Senator HERRING. Mr. Chairman, there is the call to the floor of the Senate. We will have to go over and vote. It is a record vote, and we are needed over there.

Mr. EBERSTADT. Well, I do not wonder, Senator Herring. [Laughter.]

Senator DOWNEY. Gentlemen, I feel very unhappy at not being able to give more of my time and attention to you while you are presenting this matter, but I have to withdraw now.

Senator HERRING. We will be back in 15 minutes.

Senator HUGHES. I wonder if we cannot pair.

Senator HERRING. I do not think so in this case because we are all voting the same way.

Senator DOWNEY. I hope you gentlemen will not think we are lacking in courtesy.

Mr. EBERSTADT. Oh, no. The Nation's business must go on.

Senator DOWNEY. Well, this business must go on, too.

Senator HUGHES. I will remain here, and if they need me they may call me on the phone.

Senator DOWNEY. I am reading all of the hearings—I want the witness to know.

Mr. EBERSTADT. Shall I go ahead, Mr. Chairman?

Senator HUGHES (presiding). Yes; the other Senators will return as soon as they can, but I want to proceed with the hearings and get through with them.

Mr. EBERSTADT. To the extent that they are still alive, the main sufferers from this situation have been the small local investment dealers, who in the past performed a service of inestimable value in

raising funds for new local enterprises. The loss of this source of new capital has been, in my opinion, a serious deteriment to the country as a whole. The result is that underwriting business more and more has been confined to large companies and has been increasingly dependent upon what is called Wall Street, which, generally speaking, is not equipped to finance companies of small size.

It may be said that investment trusts have not in the past been an important factor in the furnishing of capital to small companies or to new industry, and in reply I would ask, "What field has?"; and this is one of our main problems today. I am convinced from our conferences on this bill with the Securities and Exchange Commission that nobody more than the chairman of this Commission would welcome the entrance of investment trusts into this field, but I can assure you that in my opinion under existing laws and particularly under the bill before you for consideration, this is not and will not be possible.

Senator HUGHES. State that again, please. What will not be possible? There is some confusion in the room and I lost that.

Mr. EBERSTADT. The raising of new capital for new or speculative enterprises or creating ventures.

Senator HUGHES. I wanted to be sure that that was what you said.

Mr. EBERSTADT. Accordingly I recommend to your committee that this bill be given further consideration and study from the point of view of presenting a bill which, on the basis of experience in securities legislation and regulation to date, will correlate and integrate into as simple, definite, and concise form as possible the various provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and this legislation, so that as a result of such consolidation and simplification many of the barriers which now exist in the way of the free flow of capital may be removed without departing from the fundamental basis of strict truth and fair dealing in securities.

That is why I am against any bill at this time.

I have stated that I am against this bill at any time, my objection being based not on the purposes and objects of the bill, with which, generally speaking, I concur, but from conviction based on experience that, if passed in its present form, the bill would result in the same type of confusion and stagnation in the investment trust field as now exists largely as a result of present and similar legislation in the new capital field.

This bill is complicated, vague, and indefinite throughout. It goes 'way beyond what is wise and reasonable and would be definitely injurious not only to the investment trust business but through the investment trust business in greater or less degree to much other business. Many, if not most of the important provisions in the bill are subject to broad interpretation, addition, modification, or even repeal in toto at the discretion of the S. E. C. If passed, it would be simply another platform on which would be erected a monument of vague, unknown, and unpredictable rules, regulations, reports, and so forth.

Regulation is not of itself an easy cure-all for all ills of the investor. May I invite your attention to the fact that stockholders and depositors in banks in 1933 were stockholders and depositors in regulated institutions. While I have made no study or estimate of the amounts, I should doubt whether their losses were not many times the losses of security holders in investment companies. The same remark is

applicable to the holders of the securities of railroad companies which have been under regulation for many years. In my opinion the principal cause for losses of those interested in banks, railroads, and investment trusts, just as in real estate and practically every other field, was from conditions and not from occasional dramatic crimes. I have noted with interest that the most astute and experienced businessmen when they set up personal trusts do not confine their trustees to so-called "legal investments."

So much for my general remarks on the bill under consideration Others have and will speak to you in detail about other particular sections. I will confine my detailed comment to sections 10 and 1 of the proposed legislation and in the first instance, address myself to section 10, headed "Affiliations involving conflicts of interest."

Regardless of the extent to which conflicts of interest may or may not have been the cause of abuses in investment trust practice or losses to investors, I feel that such conflicts are contrary to good business ethics, favor their elimination and would welcome the inclusion in any bill of a plain, simple, and final statement without discretion, regulation, red tape, or anything else of the sort, definitely putting an end to such conflicts of interest.

There is, however, only one practical way and one effective place to accomplish this and that is by providing that a majority of the board of directors of an investment company shall be independent not only of manager, underwriter, and broker, but also of each other. No matter how long or involved the provisions of any statute may be, or how broad the regulatory power conveyed therein, nothing short of this would appear to us to accomplish the objective, and any effort beyond it accomplishes nothing further except nuisance and expense. It is in the light of this principle that I wish to comment on the particular paragraphs of section 10.

Section 10 (a): As the suggestion which I have already made goes somewhat further than the language of this paragraph, we obviously have no objection in principle to this paragraph, except that we feel that the exclusion of a broker as one of the independent majority is not justified and tends to limit the already restricted field of available directors. One broker member on a board not affiliated with any of the other directors, might well be advantageous through contributing information on prices, markets, and so forth.

Section 10 (b) is an exception to 10 (a) covering primarily a special and limited type of situation with which we are not concerned.

Section 10 (c) excludes from the board of an investment company any investment banker or broker if he is a director, officer, or manager of an investment company not in the same system.

I can see no merit in this provision, provided a majority of the board are independent and without affiliation to each other. On the contrary, it seems to me that it might be definitely desirable so long as there is an independent unaffiliated majority, to have one member of the board, even though an investment banker or broker, who might also be associated with some other investment company, from whose experience and deliberations in such other situation, definite benefit might flow. I see no particular virtue in complete isolation of thought and action of one investment company from another. In the investment field, as in every other field of human affairs, exchange of opinion and discussion should be, and usually are, productive. Naturally,

interlocking of directorates, if carried to the extreme, may not be desirable, but such a situation cannot exist where each member of the majority of the board must be independent of affiliations with each other and the minority.

Section (d) provides that the board of an investment company cannot employ as "investment officer" or "manager"—which, so far as I know, is a new creation in this field—any officer or manager of another trust not in the same system, any bank director or officer, any person who regularly acts as broker, any principal underwriter of an open-end trust, or any one affiliated with any of the foregoing. While there might be some question as to the same people managing two like competitive trusts, I can see no reason why the same group should not manage two independent and noncompetitive trusts.

Senator HUGHES. You say that is a new office or a new creation?

Mr. EBERSTADT. An investment officer, so far as I know, is an an entirely new creation. I think that is the brain child of our good friends. So I am not familiar with the habits and characteristics of investment officers. According to the definition in the bill, he looks very much like what we are accustomed to call an order clerk.

For example, the investment policy of Chemical Fund requires high-grade, seasoned stocks. It is not, and by the nature of its constitution probably never will be, engaged in underwriting or in financing of new or speculative enterprises. On the other hand, there are tremendous opportunities for development of new fields in the chemical business. It is a fast-growing industry offering sound and profitable opportunity for investment. From every economic and social point of view, it seems to me its development should be encouraged. I can see no sound reason why the fact that we are managers and underwriters of Chemical Fund should conflict with, or exclude, our organizing any such other enterprise. I feel that our acquaintance in the chemical industry through Chemical Fund particularly qualifies us for the organization of a more speculative fund in that field, if we ever desire to do so, yet by the language of this bill, we would be precluded from doing so with the result that a certain portion of capital is prevented from flowing into industry in this important and promising field. Similarly, and in spite of our rather extensive experience in the field, we would be excluded from forming an investment trust to underwrite new or speculative enterprises.

With the second section which prohibits a director or officer of a bank from being a director of an investment company, I also differ. Anyone who has faced the task of seeking directors qualified by ability, experience, and character to serve on an investment company, knows that the field is limited, that such directors are difficult to get, and that among the best qualified to act in that capacity are officers and directors of our banks. It is with great regret that I would see them excluded from acting on an investment company board, and I see no real conflict of interest, bearing in mind that this comment, as well as my other remarks addressed to this section 10 are on the assumption of the existence of an independent majority of the board not affiliated with the managers, the underwriters, or each other.

The third section excludes any person who regularly acts as broker for such registered company. On this subject, I wish only to repeat what I stated with respect to bank directors.

Paragraph (4) is the most serious and devastating of the provisions in this section in that it would appear to segregate management and distribution of open-end companies.

I was somewhat surprised to find such a provision in the bill after Judge Healy's opening remarks on the matter of segregation as follows [reading]:

nor does the bill require the segregation of * * * distributors from the management of investment companies.

The language of the bill states that it shall be unlawful for the manager of an open-end management company to serve or act as principal underwriter—which is another term for distributor—thereof. I cannot reconcile this provision with Judge Healy's remarks, and while I have criticized the bill as being vague and indefinite in many respects, I am afraid that it is extremely clear and definite in this respect.

While there are certain important and successful investment trusts where a formal segregation of sales and management prevail, the overwhelming practice in the industry is a combination of these functions in the same group. This is not a new situation, but has existed over many years. A change, therefore, would involve the disintegration of the prevailing method, which is widely and well established, and could not be accomplished without a serious upset in the management and distribution of the great majority of trusts, with possible undesirable consequences for thousands of shareholders.

I am referring there, of course, to so-called open-end trusts.

A change of so serious a nature would not seem justified in the absence of disclosure during the thorough and extensive investigation made by the S. E. C. staff of differences in practice or performance which indicated definitely that segregation of the functions had produced better results than combination, or avoided evils which experience showed to be inherent in combination of the functions of management and distribution. Such evidence, however, is conspicuously lacking both in the reports of the S. E. C. and in other statistical records of the segregated versus the nonsegregated functions.

The following quotation from its report sets forth the conclusion arrived at on this point by the S. E. C. [reading]:

The sponsors of open-end companies were classified either as sponsors primarily engaged in the distribution of securities or as sponsors primarily engaged in the management of investment funds. This classification was motivated by the desire to ascertain the effect upon performance, if any, of participation by management in the business of security distribution. The classification is admittedly broad, but the present data permit of no further gradations. In no year is there a significant difference among the means. In 3 years, the performance relative of companies whose sponsors were "distributors" was higher: In 3 years "managers of funds" performed better. It can at least be said that the available data do not afford a statistical basis for differentiating between the performance records achieved by these two classes of managers. (Report of the Securities and Exchange Commission pursuant to sec. 30 of the Public Uility Holding Company Act of 1935, pt. 2, vol. IV, ch. VI, p. 80.)

That there is no basis for differentiating between performance records finds additional support in a comparison made by Barron's in its January 29, 1940, issue of the performance of 36 leading open-end investment trusts. Classifying the 36 companies according to the type of sponsor; that is, primarily "distributors" or primarily "managers," and averaging by such classifications the performance figures given, we find the following results:

Average annual performance, classified by type of sponsorship, 1936–39

	1936		1937		1938		1939	
	Number	Average	Number	Average	Number	Average	Number	Average
Type of sponsorship:								
Distributors	24	+31.1	25	−36.4	26	+22.2	29	−3.1
Managers of funds	6	+32.1	6	−29.3	6	+19.2	7	−.8
All companies	30	+31.3	31	−35.0	32	+21.1	36	−2.7

Again, using Barron's study as the basis for a slightly different method of approach, we find that if the companies included are listed in order of performance in each of the past 3 years, the results are as follows:

In 1937, of the first 11 companies 7 represent nonsegregated and 4 segregated operation.

In 1938, of the first 10, 8 represented nonsegregated and 1 segregated operation, 1 of the 10 not being included in either group due to difficulty of immediate determination of character of operation.

In 1939, of the first 11, 8 represent nonsegregated and 2 segregated operation, 1 of the 11 not being included in either group for the reason noted above.

That is hardly a convincing case that segregated operations produce better results than nonsegregated ones.

Senator HUGHES. Can you illustrate—because you are more familiar than I am or than other members of the committee who will read the record—what you mean by segregation of management and distribution?

Mr. EBERSTADT. Gladly, Senator. Perhaps I can clarify that. The open-end investment trust is a type which continues to sell shares. It requires, therefore, the performance of two functions. One is the management of the portfolio, which is generally done pursuant to a contract approved by the board of directors and/or the stockholders. The people who are the contracting parties also are the directors on one side and the managers on the other. The other function is the continued sale of the shares, which is done generally pursuant to a contract between the directors and a so-called underwriter or distributor. The prevailing practice in the business is to have the functions of management and distribution confined in the hands of one group. That is not without exception. There are a great many exceptions. But the overwhelming prevailing practice in the industry is that the same groups enjoy contractual relations for management and for distribution.

The bill, as I understand it, purports to forbid the same group from occupying the dual relationship of management and distribution; and I have just finished reference to the S. E. C.'s report indicating that they found no difference in the performance, or at least had not at the time the report was made; and I also analyzed some statistical information published as late as January of this year. I think I can say without fear of contradiction by anybody that there is no definite difference in performance between those trusts where management and distribution are separate and those trusts, which is the overwhelming practice in the business, where management and distribution are in the hands of one group.

Senator Hughes. Thank you.

Mr. Eberstadt. The only possible conclusion to be drawn from the foregoing would appear to be that there is no evidence in the record of significantly superior performance on the part of the segregated units.

Thus, both the study of this Commission and the record of performance are such as to cast serious doubt upon the wisdom and necessity for this provision.

It would be ordinarily expected, too, that the underlying reasons for the proposed segregation would be set forth in the reports of this Commission, with accompanying citations of cases in wh ch nonsegregation had led to unhappy results, but we find nothing in these reports to indicate that this requirement of segregation represents a considered conclusion by the study group, or is based on any persuasive exposition of principle, or is called for by any abuses inherent in either the theory or accepted practice of open-end mutual-investment companies.

Whether management and distribution are in the same or separate hands, there is so close an affinity of purpose and function as to render a legal segregation merely a matter of form. Whether separate or apart, both are presumably interested, from the financial point of view, in the successful operation of the trust. Both are equally interested in the sound and healthy growth of the trust. There is a complete identity of fundamental motive and objective in management and distribution.

It is not to be assumed that by segregation the interest of the distributor in the make-up of the portfolio would be lessened, or by such segregation that the manager would be insensitive to sales peformance.

Regardless of formal and legal separation of functions, the distributor and manager remain engaged in one undertaking, which cannot be successful in either branch without successful performance on the part of both; the prestige of both are pledged to the one objective of a well managed unit; the compensation of both flows from the successful carrying out by each of his respective functions; and the motives of both, whether or not formally segregated, are not only not several and antagonistic, but are necessarily identical.

Whether the functions of management and distribution are segregated or combined, we submit that if the investment trust has an independent majority of the board of directors, such a board accomplishes an effective check on any possible conflicts of interest between management and distribution, and that this is not only the simplest and best solution but that it is actually the only true and complete solution. In principle this provision is aimed at curing an evil which does not exist by a method which would not cure it if it did.

I think it has already been pointed out to the committee that during the early years of trust management the normal and reasonable management fees frequently fail to defray the cost of good management.

In the event of segregation, the management of a trust must look forward to a considerable period of loss before recouping its costs, a risk which would seem to be hardly justified, particularly in the light of existing obstacles to the formation of new trusts, as well as certain other provisions under consideration, which must necessarily have a further serious deterring effect on new trust formation.

If, in addition to the losses of good management in the early stages, there is to be added the investment, running into thousands of dollars, necessary to defray the costs of essential preliminary studies and investigations, registration under the Securities Act of 1933, compliance with "blue-sky laws," and so forth, such segregation would appear to constitute another effective deterrent to the formation of new trusts.

Speaking from practical experience, we know that there is no essential, nor, as far as we have been able to discover, apparent conflict between management and distribution. Yet, if the two functions had been required to be segregated in July 1938, it is very probable that chemical fund would not have been formed.

This is not for any one reason, but rather springs from a combination of circumstances related to the particular nature of an investment trust. The economics of the situation would undoubtedly have been an important, perhaps almost a sufficient reason—for no one likes to make a substantial investment in time and organization expenses, to face a period of operating losses, and to assume many risks against the possibility of a return that is not compensatory. Of almost equal importance, however, would have been the unwillingness to entrust to another either management or distribution when the successful performance of both was so obviously necessary for the success of either.

The S. E. C. has created an evil that does not exist, and has set about to cure it in a way that would not cure it if it did exist.

To sum up, in view of the fact that neither in the studies of the S. E. C., nor in independent statistical information, have we found significant evidence of superior performance through segregation of management and distribution, or of a tendency to abuses when these two functions are combined; furthermore, because of the prevailing practice in the industry; because of the disruption, expense, and possible loss which would result from compelling segregation; because of the failure of segregation to meet the point at which segregation is apparently aimed, which can be more fully and better met by an independent board of directors; because of the tendency of compulsory segregation to result in a monopoly by existing large trusts; and for the other reasons indicated above, we strongly urge the committee to eliminate this provision requiring segregation of management and distribution.

Section 10 (e) prohibits any director or officer of a registered investment company from serving or acting as director or officer of any portfolio company, if such registered company owns less than 5 percent of the outstanding voting securities or such director or officer is an investment banker or broker. I cannot understand the magic of less than 5 percent. Inasmuch as diversified investment companies are restricted to 5 percent, it seems to me that no director of a diversified investment company can be a director of a portfolio company under the bill as drawn. I can see how the bill might provide that no director of an investment company could be a director of a portfolio company, but I cannot see why it is iniquitous to be a director if your company owns less than 5 percent but that the iniquity is removed as soon as you own 5.1 percent. I think the situation is stated exactly in reverse.

Going back to fundamentals, that an investment company should have a majority of independent directors, none of whom are affiliated

with the manager or adviser or with each other, I can see no harm in a director also being a director of a portfolio company, whether or not he be an investment banker, and I can see a great many benefits in the way of information, and so forth, that might flow therefrom.

Section 10 (f) provides that no director of an investment company shall be affiliated with a firm which serves or acts as principal underwriter for an issue of which such registered company owns more than one-half of 1 percent of any class of outstanding securities. 10 (g) which is related to it, prohibits the purchase by an investment company of any security, the principal underwriter of which is a director, officer, or manager, excepting where such company has itself been underwriter, or after the expiration of 1 year from the offering.

If this provision is to be taken literally, it is the end of open-end companies, because it prohibits the repurchase by an open-end company of the shares which it has issued. But I do not think that was intended, and I will disregard that criticism.

I agree with 10 (g) and feel that it is simple, clear, and goes the whole route and gives every protection to the trust. But I very much disagree with 10 (f). There again we have a magic figure—this time one-half of 1 percent. One-half percent of Standard Oil Co. in dollars and in influence is quite a different thing from 5 percent of a smaller company.

I regard 10 (f) as very definitely discriminating against the inclusion of securities of thoroughly sound but smaller companies in the investment portfolio. I can see no possible harm likely to result to an investment company from having its manager or underwriter also be principal underwriter of an issue of securities of which the trust owns, say, not over 5 percent. I can see very great harm in this prohibition as it stands. Let's take, for example, our consideration of forming a speculative company in the chemical field. Assume that through investments of this company a business was brought along to the point where it needed substantial additional capital, more, if you will, than the trust could or should supply. Could anything be more natural or logical or beneficial to all concerned than that we should underwrite for public offering an issue of the securities in question?

Please bear in mind throughout my remarks that I am taking a situation with an independent board of directors, a situation where the management contract has been approved by the stockholders as required by this bill and, so far as I am concerned, a situation where the distributing contract also has been approved by the stockholders, which are natural and not artificial protective measures.

If, as we have recommended, the trust has a majority of directors independent of manager, distributor, and each other, bearing in mind that a diversified trust cannot have more than 5 percent of its assets in any single situation, I can see nothing protective from the point of view of the trust in this section. It is apparently aimed at preventing any investment banker related to the trust from participating, as a practical matter, in the underwriting of securities which are held in the trust. I agree that the relationship of an investment banker to a trust should not be exploited, but on the other hand, it seems to me grossly unfair to penalize such a relationship under circumstances where it could not be harmful to the trust itself.

This is particularly true in the light of the complete and proper protection to the trust against dumping which is provided by section 10 (g), with which, as I have already stated, I fully agree.

With respect to (h), I have nothing to say, as obviously what the bill prohibits directly is illegal by indirection.

I am not qualified to talk on section (i) as we have no familiarity with that type of situation, but I think my foregoing remarks apply generally to that situation, which is a special type of trust.

Turning now to section 11, headed "Recurrent Promotion of Investment Companies":

Section 11 would effectively prevent the formation of a new trust by an existing and presumably experienced sponsor regardless of the purpose or function of this trust, or its relation to an existing trust to which the sponsor is related.

I am not taking up the problems that may arise from sponsorship of two trusts identical in nature. These are of a special sort and have been, or will be, discussed by others. We are concerned, however, with the situation of the sponsor of an existing trust who may be particularly qualified for and desirous of forming a new trust in no way competitive with the present trust and whose functions and purposes are quite different.

There is at present an obvious dearth of investment banking or underwriting capital. There is practically a complete lack of speculative or risk capital. There would seem to be no reason for embodying in the bill restrictions which would prevent the formation of a trust permitted to underwrite or invest in companies, too young or too small to attract public capital. Obviously most of the present open-end investment trusts may not or could not, perhaps should not, participate in this category of business, so that the entrance into this field by new trusts would, for many reasons, require a different set-up especially designed for the purpose.

The fact of the existence under like sponsorship of an established investment trust, particularly where its record is creditable to the sponsors, should not be permitted to stand in the way of the formation by them of a new nonconflicting trust. Again I qualify my statements on the assumption of an outside independent unaffiliated majority of directors. The same is true perhaps in an even greater measure with respect to a trust organized for the purpose of supplying capital to new or young ventures. The importance of this to our economy particularly at the present time would hardly seem to need stressing.

There is less necessity for this restriction, and particularly for a time limitation of 5 years, today than heretofore. The bill contains a provision for a minimum investment of $100,000. This will of itself exclude a great many possible, and all frivolous, trusts. Furthermore, the expense of setting up a trust, in addition to the investment, runs into many thousands of dollars. The time and effort necessary to comply with the requirements of the 1933 act, the "blue sky" laws of the various States, and the technical and contract papers now necessary, themselves offer an obstacle of time and expense which is a new and effective prohibition to mass production of trusts.

Most of the testimony furnished to the committee by the S. E. C. has consisted of horror stories of offenses committed by thieves or embezzlers, although practically every S. E. C. witness has spoken highly of the great majority of the individuals in the business. I do not minimize the seriousness of these wrongdoings, but it hardly seems reasonable to legislate and regulate on the basis of these scandal stories.

And so I strongly urge that instead of adding to the present mountain of laws, rules, regulations, releases, and bulletins which constitute ever-increasing barriers to the free flow of capital, without departing one iota from the strictest application of the doctrine of "truth and fair dealing in securities," you treat the subject of investment companies as part of an examination of the general field of capital investment, which well merits your constructive attention on the basis of the 7 years' experience which we have had under existing laws and regulations. Most of these acts can and should be preserved, but there is a massive barnacle growth of incidental, irrelevant, burdensome, dilatory, and expensive detail which must be stricken down if the free flow of capital is to be restored.

I thank you.

Senator HUGHES. Did you state where your business is located?

Mr. EBERSTADT. New York City, sir.

Senator HUGHES. Have you something more that you would like to say?

Mr. EBERSTADT. I just had a note handed to me and, with your permission, I will read it.

Senator HUGHES. Very well.

Mr. EBERSTADT (after reading note referred to). I have nothing further, sir.

Senator HUGHES (presiding). Mr. Roger Amory will be the next witness, I understand.

STATEMENT OF ROGER AMORY, PRIVATE TRUSTEE AND DIRECTOR OF VARIOUS COMPANIES, BOSTON, MASS.

Mr. AMORY. My name is Roger Amory. My address is 19 Congress Street, Boston, Mass. My occupation is that of private trustee.

In the very brief statement which I am about to present I am trying to make five different points. First, I want to say that I am an investor, and I am appearing here in the capacity of investor and in that capacity alone. I want to point out the type of information that the investor should have and be able to rely on as to the fundamentals of it. I will speak then of the nature of the abuses of investment trusts, as I see them, and the suggested remedies for such abuses, and then state why I am opposed to S. 3580.

First, in order to show my position as an investor, I serve as executor, trustee, guardian, financial agent, and family adviser, which includes advice on financial matters. I serve as officer or director of real estate and personal property investment trusts, and as a director or member of investment committees, trust committees, and executive committees of various banks and of an insurance company. I have been in the business of investing other people's money for over 28 years. It is my sole business.

As trustee under wills and indentures or as guardian, I have a voice in the investment of approximately $30,000,000.

As agent, family adviser, or treasurer of a charitable organization, I have a voice in the investment of approximately $12,800,000.

As trustee or director of real estate trusts, I have a voice in the investment of approximtely $4,600,000.

It might be said that this is the major part of my business. However, I do not distinguish in my mind or in my efforts between the

fiduciary treatment of investment problems in any of the foregoing capacities and in any of the following ones:

As trustee, director or member of the advisory board of investment trusts, I have a voice in the investment of approximately $141,700,000.

As director or member of investment or trust committees of banks and of an insurance company, I have a voice in the investment of approximately $497,000,000.

In other words, I have a voice in the investment of approximately $686,100,000.

This is a very large total, but I want to point out that of it I personally control the investment of less than one-tenth of 1 percent, and this one-tenth of 1 percent represents almost entirely funds of my own family. All the rest is subject to the joint control of co-trustees and co-members of the boards and committees on which I serve, and here, of course, I have only a voice as part of the group in controlling the investment.

I give these figures to show that I am engaged primarily in making investments.

When judging the advisability of investing in a security, I must consider.

1. The ability, integrity and experience of the officers and directors of the company which issues the securities.
2. The financial condition and earning record of the company, its financial structure, and the nature of the security in question.
3. The nature of the business.
4. The extent of the interest, financial and otherwise, of the officers and directors in the company.

I believe that investment trusts perform a legitimate function in the economic life of the country. I believe that securities of investment trusts are useful and desirable mediums of investment for small fiduciary accounts and for individuals of small means desiring diversification of risk.

I believe that the abuses of investment trusts have arisen—

1. From abuse of the corporate structure itself which makes it possible for officers and directors to avoid fiduciary responsibility; which permits the superimposing of one company on another; which allows the directors to act without any financial risk on their part, and, further, allows them to sell out their stewardship.
2. From failure of the officers and directors charged with the care and management of the investors' money to conform to the long-recognized rules of fiduciary conduct.
3. From failure by the management of investment trusts to give accurate and adequate information to the stockholders and prospective stockholders.

It seems evident that some form of legislation is necessary in the interests of the public to prevent these abuses. The States have power to cope with these problems and many of them are making efforts to do so; but if Congress considers that Federal legislation is necessary and within its constitutional authority, then I believe that such legislation should be along the following lines. The philosophy back of these suggestions which I am about to make is—

> that it is not possible to make men honest by either legislation or supervision, or by both, but that it is possible to make unethical procedure illegal.

A. All investment companies, whether or not heretofore registered, should be required to register with the Securities and Exchange Commission and to furnish to the Commission full information as to the nature of their business and as to the qualifications of the management and other persons connected with the business.

B. To eliminate the abuses outlined above the legislation should provide—

(*a*) that the directors and others participating in the management of a company shall assume the same responsibility and use the same degree of care and skill which an ordinary prudent man would use under the circumstances in the conduct of his own affairs and that no contractual waiver of that responsibility should be permitted;

(*b*) that no investment trust shall be allowed to purchase shares in another investment trust except on specific authority given by the stockholders for each individual purchase;

(*c*) that the directors shall own and hold unhypothecated qualifying shares in amounts at least as great as those required of directors of banks and that certificates to that effect shall be filed annually with the Commission;

(*d*) that in the case of a company having directors elected by the stockholders, there shall not be in office at any time directors who have not been elected by the stockholders, who in number constitute more than one-third of the directors then in office, and that in the case of a company where the directors are not elected by the stockholders that no more than one-third of the directors be changed within a 12-month period without approval of the stockholders.

C. To eliminate the abuses outlined above under 2 the legislation should provide:

(*a*) that no financial transaction between an investment company and any of its officers or directors shall be entered into unless specifically authorized by the stockholders and a full disclosure of all profits arising therefrom is made in the periodic reports to the stockholders;

(*b*) that every management and distribution contract made with an investment company shall be terminable by the investment company at the will of its board of directors whenever a majority of such directors shall not have been directors at the time the contract was made.

D. To eliminate the abuses outlined above under 3 the legislation should provide:

(*a*) that investment companies shall be required to give to their stockholders and make available to prospective purchasers of their stock adequate financial statements and information as to the nature of their business and the qualifications of their management. The periodic statements furnished to stockholders should contain accurate statements as to the nature of the business, the policies of the management, the arrangements made for custody of the assets, and the affiliations of the officers and directors in each company in which the investment company owns securities or with which it has any contract. These periodic statements shall be in such form as seems best to the management.

I will stop there to make the point that in my opinion the directors, holding, as they do, a fiduciary position to the stockholders, should put the reports in form so that the stockholders will understand them.

I am very much opposed to the Securities and Exchange Commission or anybody, other than the directors, determining the form in which that information is presented to the stockholders. If some agent other than the directors decides what form they shall take, it may be misleading to the stockholders; and I think that the directors themselves are responsible to give their stockholders a true picture.

Senator HUGHES. May I interrupt you a moment?

Mr. AMORY. Certainly, Senator.

Senator HUGHES. That has caused me some thought, too. I take it that you think that the directors should give a statement. Would it be sufficient, to your mind, that the bill should provide for a comprehensive statement? Would you stop there?

Mr. AMORY. I would stop there.

Senator HUGHES. Or would you say, "covering the following"?

Mr. AMORY. "Covering the following points"; yes; I think I would.

Senator HUGHES. It would be a sort of direction by statute as to the general outline of the statement?

Mr. AMORY. Yes, sir. When I come to (*b*) you will see the point that I am trying to make.

(*b*) that all investment companies shall be required to file with the Commission audited statements in such form as the Commission may prescribe and that these statements shall be made available to the public by the Commission.

A great protection to any stockholder is the statute regarding using the mails to defraud; and that is the theory that I am working on. If there is any fraud used, it would be easy to pick it up.

(*c*) that all notices, reports, and other material sent by investment companies to their stockholders shall also be sent to the Commission;

(*d*) that all prospectuses and other selling literature distributed by the underwriter to prospective stockholders shall also be sent to the Commission.

This does not mean that the Commission shall approve them. It means that we lay our cards on the table.

Such legislation, together with that which is already on the statute books, would, in my opinion, prevent (so far as any laws can prevent) abuses that have occurred in the management of investment trusts.

I would like to state here that not only have I read the proposed law in detail, but have had it read to me by a lawyer so as to have him explain what it meant. And then I have read all the evidence that has been presented to your committee, and most of the exhibits. In my opinion, those things would cover nearly all abuses that have been brought out.

I am opposed to the proposed bill (S. 3580) for the following reasons:

1. Because to an unnecessary degree it transfers the law-making powers of Congress to a commission which is in no way responsible to it.

2. Because it endeavors to insure honesty through legislation by providing supervision which, in my opinion, would be entirely inadequate for the purpose, burdensome to the management, and expensive to the investor.

3. Because it will favor the larger trusts over the smaller trusts in obtaining necessary advice.

4. Because it allows the Commission to control a business that is so varied in form and complex in nature and so dependent on personal judgment that no single group of men could understand all phases of it, no matter how experienced they were in any particular field.

5. Because it subjects the Commission to the possibility of acting through subordinates on snap judgments, on inadequate information or from dishonest motives.

6. Because it will eliminate from the management of investment trusts that type of responsible individual most helpful and best trained for such work.

7. Because it will increase the cost of administration and reduce thereby the income to the investors.

I thank you.

Senator HUGHES. Thank you, Mr. Amory.

Senator HUGHES (presiding). The next name that I have on my list is Mr. Hugh W. Long.

Mr. LONG. I am here, Senator.

Senator HUGHES. We will hear you now, sir.

Mr. LONG. Thank you.

STATEMENT OF HUGH W. LONG, PRESIDENT, NEW YORK STOCKS, INC., AND MANHATTAN BOND FUND, INC., NEW YORK, N. Y.

Mr. LONG. My name is Hugh W. Long, and I am president of New York Stocks, Inc., and of Manhattan Bond Fund, Inc. Both of these are open-end investment companies. New York Stocks, Inc., has a portfolio consisting entirely of marketable stocks; Manhattan Bond Fund, Inc., is restricted by its charter to investment only in marketable bonds. Both have the wide diversification of investment necessary to comply with the mutual investment-company provisions of the Internal Revenue Code. They are companies of moderate size; at present, one has a net asset value of about $10,000,000; the other about $5,000,000.

These companies were not sponsored by any investment banking house or brokerage firm and they are not managed by either. From their inception, their charters have contained prohibitions against self-dealing by officers or directors, short selling, margin trading, loans, borrowing, pledging of assets, and certain other practices condemned by the S. E. C. and prohibited by the proposed act. Their securities have been sold at a moderate sales load to a substantial number of investors through registered investment dealers in various parts of the country. In these respects, I believe, they are typical of the large majority of companies now operating in the open-end field.

I am also the president of Manhattan Foundation, Inc., the investment adviser for both of these companies, and of Hugh W. Long & Co., Inc., which is the wholesale distributor of the securities of both. The majority financial interest in Manhattan Foundation, Inc., is held by a number of persons not identified with either investment company or with Hugh W. Long & Co., Inc. My associates and I, however, control both of these companies. Both the advisory company and the distributor operate under separate contracts with the two investment companies.

This statement is devoted first to a consideration of those portions of section 15 of the proposed act which provide:

(a) That no person shall serve as a manager or investment adviser of a registered investment company except pursuant to a written con-

tract, approved by the vote of a majority of the outstanding voting securities of the company which—

(1) by its terms expires not later than two years from the date of its execution and is renewable thereafter only annually; and

(2) may be terminated at any time, without the payment of any penalty, by the board of directors of the company or by vote of a majority of the outstanding voting securities, on not more than sixty days' notice.

That is, the contract may be canceled on 60 days' notice.

At the outset, let me say that we approve without reservation those provisions of section 15 which require that the compensation of management be precisely defined and which provide for the cancelation of management and distributing contracts upon assignment of a contract or transfer of control of the company holding it. We quite agree that there should be no opportunity for investment companies to be "sold down the river." Although the transfer of a personal-service contract of a fiduciary nature is probably a violation of ordinary rules of law, we see no objection to a specific prohibition in this statute.

Furthermore, we are in full accord with the statement made by Judge Healy on the opening day of these hearings to the effect that "we ought to develop a group of expert investment trust managers" capable of providing "wise and careful management of the funds entrusted to them." We sincerely believe, however, that it would be impossible to develop or continue that type of management for investment companies under the limitations contained in this bill.

Here are my reasons for thinking that:

The type of organization capable of rendering efficient and valuable investment advisory or management service to investment companies is not the sort that consists of a desk, a chair, a few books, and one ex-accountant. On the contrary, to do a good job, one of these advisory organizations must have a substantial, permanent, trained staff to do extensive research, statistical and analytical work. It must be operated by persons trained in security analysis—not statisticians or customers' men or industrial plant managers, but investment analysts, possessing the background and experience necessary to make a critical evaluation of investments. It must lease space, purchase equipment, employ clerical help. Contracts must be entered into for statistical services, library facilities, and so forth. Its more important personnel must have some security of tenure, which means salary contracts. If the organization employs, as many of them do, economic experts of high caliber, it can do so only on substantial retainers and for long terms.

Research organizations of this sort can be built and maintained only upon some assurance of a steady flow of income. No really competent organization could afford to undertake to perform a short-term contract, terminable capriciously and at short notice.

If the organization which does this work is a "manager" as distinguished from an "investment adviser" (using the terminology of sec. 10 (d)), it can, under the bill, serve only one investment company (sec. 10 (d) (1)). It is prevented from obtaining the economies

and advantages of serving an aggregation of capital from several clients. In other words, it must do only one job, and be prepared to go out of business on 60 days' notice.

If this 60-day provision remains in the bill, its only effect will be to put a high premium on bad management.

The proposed measure which permits a contract to be canceled on 60 days' notice by vote of the shareholders, constitutes a direct invitation to raids upon the management of every established investment company.

Fly-by-night organizations posing as investment counsel, will, as surely as day follows night, appear upon the scene and attempt to cut the ground from under existing management by offering to reduce the management fee. Under the proxy rules, the material of these raiders must be sent to the stockholders—and the stockholders will have no adequate standard of judgment except the difference in cost. Once the pirates are in, they will be subject to the same attack by other hijackers. The field will be wide open to strike tactics and shyster practices. The net result will be to vest the management of investment companies in the very class of persons it is desired to exclude.

In the case of an open-end investment company, there is a close coordination of interest between management and distribution of securities. In these companies, shares may be redeemed by the stockholders at their option. If the funds thus withdrawn are not replaced by the concurrent sale of other shares, portfolio securities must be liquidated. In order, therefore, to keep the capital funds at an efficient operating level, there must be a constant and steady distribution of securities—just as, in the case of an insurance company, there must be a constant sale of new policies to replace those matured or lapsed. Management cannot do a good job if the amount of funds at its disposal is subject to rapid gyrations. Distributing organizations, therefore, as well as management organizations, must have a reasonable degree of stability.

Management or advisory contracts, under the bill, may be made for an initial period not exceeding 2 years, but the initial period for distributing contracts with the principal underwriters of open-end companies is limited to 1 year. Aside from the question as to whether 2 years is long enough in either case—we do not think it is—there does not appear to be any valid reason for this distinction.

An underwriter distributes through dealers, and to do a good job he must have a good many of them. Good dealers are not available at the snap of one's fingers; they must be sought out, educated to the merits of a security, and persuaded to sell. The formation of a group of dealers requires a substantial investment in time, traveling expenses, advertising, literature, quotation facilities, telegrams and postage, as well as the establishment of an efficient field and internal organization for handling the details of the business. The securities must be registered under the Securities Act of 1933 and under the "blue sky" laws of the various States—all of which requires time and the expenditure of money. No one is going to build such a structure at the risk of seeing it collapse before he has begun to recover his investment—and of having the results of his efforts handed over to someone else for nothing. Unless the distributing contract can run for an initial period sufficient to permit the underwriter to recover his original outlay,

underwriters of proper qualifications will not be available for this business.

One other factor must necessarily enter into any consideration of these contracts. That is the expense of the initial organization of the issuing company.

We have heard a lot here about $500 being run up into millions; but we know of no way of accomplishing such miracles honestly.

Senator HUGHES. Excuse me; I thought that was an illustration of how it could be done dishonestly.

Mr. LONG. I think that is true in most cases.

The organization of an open-end investment company and the operation of it until it earns its own way involves the expenditure of substantial sums of money, running into many thousands of dollars. This money must be supplied by someone. It cannot be provided by the stockholders of the fund; most of it must be spent before there are any public stockholders. Even with the proposed requirement of $100,000 initial capital, the organization and development expense must come from outside of the investment company itself, since no reputable distributor would offer securities of a company whose initial balance sheet shows a large capital deficit—due to organization expenses. Such a security could not be qualified under the "blue sky" laws of most States.

The expense of organization and development, therefore, is borne by the so-called sponsors who expect to and usually do manage the company after it has procured capital for investment. There is nothing nefarious about this; there is not the slightest indication that people who organize open-end investment companies are not qualified to manage them. On the contrary, organization—which includes the distribution of securities—can be accomplished only by those in whose management the public has ultimate confidence.

Having expended these substantial amounts of money, however, the managers of the fund must have some reasonable time in which to recoup their investment before they can be ousted from their proper employment. We believe that 1 or 2 years is not enough for this purpose. With a reasonable charge for management services and the expenditure of proper amounts for maintenance of the facilities necessary to render efficient service, the profit is not so large as to permit rapid recovery of the initial expenditure. Honest management should be allowed adequate time for this purpose. To deny it, would tend to restrict this field to organizations bent upon the rapid recovery of investment by the dishonest practices which this legislation seeks to prevent.

Finally, we must not ignore existing contracts which have been entered into in good faith for a term of years and still have substantial periods of time to run. We feel sure that the Congress would not expect deliberately and unqualifiedly to legislate these contracts out of existence. Although this is properly a matter for counsel rather than for the manager of an investment trust, one cannot help raising the question of the constitutionality of such a provision.

Yet, the proposed act provides that after 1 year from its effective date no investment company can operate under any such contract. However, the contracts are there. The investment companies cannot simply cancel them out of hand, without compensation to the other parties who have made a substantial investment on the faith of these

contracts. The necessity for complying with this provision of the proposed act is likely to cost the investment companies such very substantial amounts of money as to offset any possible benefits which may be derived from the administration of the act.

I must emphasize that the point of view I am expressing on this point is entirely realistic. In our situation the investment companies have boards of directors, the majority of whom are entirely independent of either the distributor or the investment advisory company. Neither of the latter controls either investment company; these are controlled by their thousands of stockholders. The financial interests in the advisory company and in the principal underwriting company are extremely diverse, and they have separate and independent boards. Under these circumstances, we cannot predict that the advisory company, which made the initial investment and has not yet recovered it, will, without compensation, be willing to relinquish its contracts. It could not properly be required to do so.

Our suggestions for improvement of the provisions of section 15 of the bill are, first, provide that management, advisory, or distributing contracts may be made for an initial period not exceeding 5 years, renewable thereafter annually, as now provided in section 15 (b) (2); second, provide that a company may continue to operate under existing contracts for not more than 5 years from the effective date of this provision; third, eliminate paragraph 15 (b) (3). That is the one about the 60-day cancelation clause.

I should like to turn back for a moment to those provisions of section 10 of the bill which seek to prohibit two or more investment companies from having the same manager or investment officer, or a majority of directors in common. This point has been touched on this afternoon, but it has special application in my case, which I think you would like to know about.

The two companies with which I am connected have the same board of directors—identical boards, the majority of whom are independent, disinterested businessmen of experience and judgment. These two companies have the same investment officer, who receives no direct compensation from the investment companies. I act as executive head of both companies; I have had over 20 years' experience in the investment field, during the last 10 years of which I have been connected with the administration of investment trusts. I do not draw a salary from either investment company.

If this bill is enacted into law, we must drop some of our valued directors and must attempt to find others. I must resign as president of one company or the other, which must find and pay another chief executive. Each investment company must employ a separate investment officer, pay his salary, and provide him with an office and with secretarial and other assistance. I estimate that the aggregate additional expense to each of these investment companies will be in the neighborhood of $25,000 to $30,000 a year, which must be borne by the shareholders.

Where the portfolios of the companies are of an entirely different character, as in the case of these two companies, there seems to be no good reason for the application of these provisions.

Here there can be no question of conflicting interests, divided loyalties, or concentration of economic power. We do not approve of these provisions of section 10; but whatever may be the ultimate

decision as to their application to investment companies in general, there should be a specific provision in the bill to the effect that they shall not apply under the conditions I have described, where the two companies have entirely different portfolios. One buys only stocks; one buys only bonds; there cannot be any conflict, in the administration of those two portfolios.

Senator HUGHES. Except that each has the same board of directors?

Mr. LONG. The same board of directors.

Senator HUGHES. The same manager?

Mr. LONG. That is right.

Senator HUGHES. The same president?

Mr. LONG. The same chief executive officers; that is right.

Senator HUGHES. The same president?

Mr. LONG. That is right.

In conclusion, I should like to reiterate the statement made by other members of this industry: We do not object to reasonable Federal regulation directed toward elimination of the frauds and looting described in the early days of these hearings. We believe, however, that this bill goes far beyond the necessities of the situation, and gives the S. E. C. such extensive control over the actual operation of the business as to increase materially the expenses borne by the shareholders, and to interfere seriously with free management, efficient conduct of the business, and the interests both of investors and of managers.

Thank you.

Senator HUGHES. Do you have any questions, Senator?

Senator HERRING. No; thank you.

Senator HUGHES. All right.

Mr. LONG. Thank you, Senators.

Senator HUGHES. All right; Mr. Curtis, will you come forward, please.

STATEMENT OF CHARLES P. CURTIS, JR., TRUSTEE, CENTURY SHARES TRUST, BOSTON, MASS.

Senator HUGHES. Will you proceed, please, Mr. Curtis?

Mr. CURTIS. My name is Charles P. Curtis, Jr. Senator, I come from Boston, Mass.; and I am speaking for Century Shares Trust, of which I am one of the five trustees.

Century Shares Trust is an open-end management investment company, under section 5 (a) (1), and it restricts itself to insurance stocks and bank stocks. It was organized in 1928, as a Massachusetts business trust. I do not think I need to go into their history. If you have not had it stated to you, I am sure that you will hear a description of the history and the character of the Massachusetts business trust. The oldest in the investment field is the Boston Personal Property Trust, which was drawn up in 1893 by former Secretary of State Olney, as I understand.

Century Shares Trust is younger. It was started in 1928; but it was built into that tradition. Three of our five trustees are themselves individually trustees. Charles F. Adams, whom you heard this morning; Robert H. Gardiner, who is president of the Fiduciary Trust Co.; and myself.

We are not one of the largest trusts; we have about $13,000,000 and about 4,500 shareholders. We are open-ended, and we are selling

and redeeming our shares all the time. Our shares are registered under the Securities Act of 1933.

I should like to address my few remarks chiefly and almost wholly to the provisions of the bill which require the shareholders to vote on certain subjects; and their effect, as I believe, on the nature of our trust, as a trust.

Our trust indenture requires the written consent of the holders of a majority of our shares to any form of amendment made by the trustees in the provisions regarding the distribution of income and in the provisions regarding the redemption of our shares, and also, of course, in the provisions with respect to how the trust indenture should be amended.

Otherwise, the trustees, by unanimous action, can make other amendments; but, of course, the shareholders have to be notified; and other amendments may be blocked by the holders of 10 percent of the shares filing notice of their opposition and objection. We believe that those provisions adequately protect our shareholders' interests; otherwise, except for those provisions I have referred to, our shareholders leave the entire management of the trust to our five trustees—because, as I think I shall show, otherwise we would not be a trust.

That, we believe, adequately protects our shareholders' interests. None of them has ever asked us for more control than this over their trustees. Why should they? They really are voting all the time. They know that they can redeem their shares and get back the liquidating value at any time they choose; and that includes any time they decide they do not like the way we are managing their affairs.

They have, we believe, something more than a vote. Each one, so to speak, can call his own shareholders' meeting, so far as it concerns himself, and vote by redeeming his shares. They are watching us all the time, and we know it. They are watching us especially every quarterly statement we make. That quarterly statement in a sense is our proxy statement. My point is that they are always voting, and we know we shall lose them if they are not satisfied.

This bill proposes to require the shareholders to vote on several issues. One is the election of the trustees (sec. 16); another is the approval of all management contracts (sec. 15 (b)). Another is any change in what is considered a fundamental policy of the trust (sec. 13 (b)). There is also a vote required on the selection of accountants.

I hope that the committee will consider what these voting requirements may do to a business trust. The essential character, you know, of a business trust lies in the trustees' exclusive management and control. If the trustees are subjected to the control of the shareholders they cease to be trustees and they become simply managers or agents for the shareholders. The shareholders then, if they are associated together in meetings, as this bill calls on them to be, become partners. The trust, so-called- becomes a partnership; the shareholders, being partners, become personally liable for the debts and liabilities of the business.

I hope this committee will sufficiently consider those possible consequences.

Senator Hughes. Pardon me, Mr. Curtis, that is a new thought to me; that they become partners, and, therefore, responsible.

Mr. Curtis. Yes; as partners, they become responsible for the debts of the business.

Senator Hughes. Yes. Your company is an incorporation, is it not?

Mr. Curtis. No, this is a trust; and I am talking about trusts. We are not a corporation.

Of course, some of them are.

Senator Hughes. You may be right, but it is a new thought to me.

Mr. Curtis. I should like, if I may, to quote and cite for you, Senator, as briefly as I can, some law on that phase of the matter.

Senator Hughes. Very well.

Mr. Curtis. I should like to quote from the Circuit Court of Appeals for the Eighth Circuit, in a well-considered opinion—quoting from the Texas Court of Civil Appeals. This is the case of *Otoe County National Bank* v. *Delaney* (88 Fed. (2d) 238):

> From the authorities consulted and hereafter referred to it seems that in order to create a trust which exempts the beneficial owners of the property from liability for the debts contracted by the trustee in his official capacity, the latter must have the legal title and the exclusive right of control and management of the trust property for a term, or for the accomplishment of a definite purpose. It must be made to appear that during that time the cestui que trust can exercise no power over the property except to receive the benefits and insist upon the execution of the trust agreement according to its terms.

Those are the words of the Texas Court of Civil Appeals, in *Morehead* v. *Greenville Exchange National Bank* (243 S. W. 546). They were quoted with approval by the Circuit Court of Appeals for the Eighth Circuit, in 1937.

The Massachusetts law was expounded in the case of *Williams* v. *Milton* (215 Mass. 1), where the Boston Personal Property Trust was held to be a true trust. It was later expounded in other cases.

In 1914 there was an association which called itself a trust, but it was held not to be a trust but a partnership, because the shareholders had the right to remove the trustees and appoint new ones, and had a right to amend the trust, and had a right to terminate it (*Frost* v. *Thompson*, 219 Mass. 360).

The latest case was decided by the Massachusetts court less than 2 months ago, in the case of *First National Bank of New Bedford*, v. *Chartier*, as reported in the Massachusetts advance sheets. There the Textile Loan Co. called itself a company. It was not a corporation. It regarded itself as a trust; yet all the shareholders were held liable to a creditor, because the court found that in fact it was not a trust but a partnership. The provisions which the court held gave the shareholders sufficient control to make them partners were that the officers were elected annually, that the shareholders had a right to remove an officer for cause, but only for cause; and that the bylaws could be amended by a vote of two-thirds of the stockholders. That, the court held—

> left in the shareholders the ultimate power of control of its affairs with the result that the relationship of partnership and not that of a trust was created.

Senator Hughes. Might it not be called—and there is such a thing, I believe, in some States—an unincorporated association, like the Adams Express Co. was?

Mr. Curtis. Yes; and in Massachusetts and under these decisions that unincorporated association would be called a partnership, and the partners would be held liable, if they have more than so much control.

Senator Hughes. Yes.

Mr. CURTIS. Now, Senator, opinions differ as to whether a provision requiring the election of the officers—the trustees, so-called—would in itself turn our trusts into partnerships.

Judge Magruder, recently appointed to our First Circuit Court of Appeals, wrote an article in the Columbia Law Review (vol. 23, p. 423), in which he expressed the opinion that the mere power of election would not make shareholders partners.

Judge Brewster, of our district court, expressed a similar opinion.

It may be that that alone would not make them partners. On the other hand, opinions differ.

The California Supreme Court has said:

It is generally held that the power to elect trustees and to fill any vacancies in the board gives the certificate holders such ultimate control over the trustees that the organization will be treated as a partnership and not a true trust. That rule appeals to us—

the California Supreme Court says—

as the correct one to apply.

That is in the case of *Goldwater* v. *Oltman* (210 Cal. 408).

This bill, however, requires the manager of an investment company to have a written contract—proper enough; that written contract must be approved by the vote of a majority of the outstanding shares.

Now the bill begins to give them direct control. But not only must that written contract be approved by a majority of the shares, but section 15 (b) gives those shareholders power to terminate that contract at any time, and power to hire and fire the manager of the trust. That seems to me to deprive the trustees of that exclusive control and management of the trust estate on which the courts relied, and which the courts undoubtedly require before it can be held that such an organization is a trust. That is the necessary requirement, in order to make it a trust—without which the shareholders become individually liable.

There is also the requirement of section 13 (b) that any change in any fundamental investment or management policy must be authorized by vote of a majority of the outstanding shares. The Securities Commission is given authority to designate what policies are fundamental; in other words, they are given the authority to say where the ultimate power of control of the trustees over their policy ends and where the ultimate powers of the shareholders begin.

Even if the power of election, alone, may not turn the business trusts in the investment field into partnerships—the hiring and firing of the manager by the shareholders—and this power over the policy will, I submit to the committee, turn every investment company which now operates in the form of a trust into a partnership.

Senator HUGHES. And you would not issue much stock?

Mr. CURTIS. I think it would surprise the shareholders of a trust to be told that they were liable for the debts. Of course, usually the assets will take care of that; but suppose they did not. It would surprise them, Senator, I think.

Moreover, section 17 (f) (2) of this bill specifies that after 1 year any provision in a trust indenture which purports to relieve "any affiliated person"—

from any duty or liability to such company or the security holders thereof to which such person * * * would otherwise be subject—

is unlawful; and an affiliated person, according to section 45 (a) (18) (D), includes a partner.

We believe that these provisions of the bill will eventually destroy us, and, with us, all other business trusts as trusts. I believe I am, speaking for all business trusts. I am speaking, of course, particularly for Century Shares Trust. I believe I am speaking for all its 4,500 shareholders, who, as I say, would be vastly surprised to find themselves partners of each other.

However, then we go on further. Why should our shareholders be forbidden, in effect, to use the trust form of business trust, which has had an honorable and respected career, for their use in making their investments? Why should they be put to the expense of the elections, of the machinery of getting their approval of these things? It is their expense, after all. Century Shares takes pride in keeping its expenses low. Our expenses are 10 percent of income—which we believe are about as low as any.

More than that, why should not a person reasonably prefer to have the men who are going to take care of his money in the future selected by those whom he has chosen to take care of it now? He knows who they are. Why should he have to have them selected by other shareholders whom he does not know and cannot know? Why require that of him?

He puts his money into the hands of certain trustees. He knows who each one of them is. If one of them dies or retires, why should not the shareholders be allowed to have that trustee's successor chosen by the rest of the people whom the shareholder knows? He knows that they will think hard about a new colleague. He knows they want the trust to go on, not only with the permanent policy but with the same sort of men, with the same sort of attitude toward investing his money that they had when he bought his shares.

Why should he be made to rely on the choice of a majority of the other shareholders, perhaps on the choice or on the nomination of some unknown individual who has purchased enough shares—if perhaps not enough, necessarily, to control—so that his suggestion and his nomination of a new officer must be given great consideration—and even, perhaps, suggesting or nominating himself?

I do not say that that choice will necessarily be bad or even worse; but what I do say is that there is no reason why he should not be allowed to think that the surviving trustees whom he has chosen might do it better than his other shareholders.

Now, Senator, if there were anything nefarious in the trust form, I could understand and we could understand why they should be practically outlawed from the investment field; but I take it no one will say there is anything nefarious in the form of a trust, as distinguished from a corporation. I think everyone will agree that it has proved its merit and gained honor in a field of business where it ought to be permitted to continue.

I hope the committee will think long, before it makes the trust form unavailable to the public, in the field of investments.

There is one other point I should like to make, and then I am through; that is the unfortunate vagueness of the bill, in its definition of an investment officer. That is section 45 (a) (15). Century Shares has been asking our counsel what these provisions mean and what is the difference between an investment officer and a manager.

The "manager" is defined, two sections later—in section 45 (a) (17); and we should also like to know whether these definitions particularly apply to one of our trustees. Our counsel, I think, is entirely—and, it seems to me, justifiably—unable to advise us with respect to this matter, as it applies to our trustees.

Now, Senator, whatever the opinions of our counsel may be and whatever the opinions of the proponents of this bill may be, and whatever they think these particular definitions mean, is one thing; but what we are concerned with, and what every trustee of any investment company is going to be concerned with, is the future interpretation of these definitions by the courts. We hope that these matters will be made clear enough so that anyone may know, when he accepts a position in an investment trust or decides whether he ought to continue in office, when some other position is offered to him, whether he is violating the provisions of section 10 (d).

As I say, one of our trustees, with the best of advice, is unable to tell. We want him, and he wants to remain with us. If he must choose, we want him to be able to choose; and I submit that the present definitions make it impossible for him to do that. He has got to play safe—too safe.

When I say "too safe," why shouldn't a man who lacks discretion and who is simply empowered to execute or order the execution of purchases or sales of securities—which is the definition of the investment officer as the bill now stands—in other words, a man who does no more than obey orders, without exercising his own discretion—why should he not be at the same time an affiliated person? Why should he not be connected with an underwriter or whomever? Does an investment officer, as defined here, include one who simply carries out the decision of the board of trustees to buy or sell a certain security? If that is the meaning of that term, then we do not see why, on our trust board, we should be prevented from having the benefit of a man who is, under the definition of the section, an affiliated person, just because he does that sort of thing.

We suggest that the definition of "investment officer" be simply dropped out or, at least, that the definition in section 45 (a) (15) be made clear so that he is someone whose function includes the exercise of judgment, and not simply a man who obeys orders.

As it stands, the provisions of section 10 (d) and the definition of "investment officer" in section 45 (a) (15) will force a great many honorable, law-abiding citizens from enjoying perfectly proper and perfectly useful affiliations and interests and connections; and we can see no reason why they should be forced to give up these connections and relationships.

However, those are minor matters compared to the point I want to emphasize: that the provisions of this bill, giving these powers to the shareholders, will drive an old and honorable method of doing business out of the investment field—to wit, the Massachusetts business trust.

I should like to submit these lines of an amendment which, as I see it, is the only way to prevent that happening. I should like to submit a new subsection, lettered (c) to be added to section 45, and to read as follows:

(c) The provisions of subsection (b) of section 13, subsection (b) of section 15, of section 16, and of subsection (a) of section 32 shall not apply to any registered

investment company organized or established as a trust pursuant to the common or statute law of the State in which it was organized or established, and the provisions of section 18 relating to voting rights shall not apply to any security issued by such company.

That is the end of the suggested clause. Those sections are the sections which require the majority of the shareholders to approve management contracts and allow them to terminate them, to elect trustees, to approve any change in fundamental policies, and to approve the selection of accountants.

Senator HUGHES. That would go at the end of what section?

Mr. CURTIS. A new subsection (c) added to section 45; that would be added to section 45; yes.

Senator HUGHES. This thought occurs to me: Would your amendment apply to trusts hereafter created, as well as trusts already in existence?

Mr. CURTIS. I think that ought to apply to all trusts hereafter; because I think it is a form of doing this sort of a business that ought to be kept open and allowed in the future, just as much as it has been allowed in the past, and to allow the present ones to have competitors in the future.

Senator HUGHES (presiding). Thank you, Mr. Curtis.

Mr. CURTIS. Thank you very much, sir.

Senator HUGHES (presiding). Mr. Eaton, please.

STATEMENT OF CHARLES F. EATON, JR., PRESIDENT, EATON & HOWARD, INC., BOSTON MASS.

Senator HUGHES. Mr. Eaton, will you proceed, please?

Mr. EATON. Senator Hughes, I am Charles F. Eaton, Jr., president of Eaton & Howard, Inc., investment managers or investment counselors. I represent perhaps the only firm of recognized investment counsel appearing under title I. We have our principal office in Boston. By the way, sir, my office as president of Eaton & Howard, Inc., is the only office I hold and the only office I have ever held. I have held it since our firm was incorporated.

I feel that I must tell you something of the business of the company which I represent, in order to make clear to you what I consider to be some of the problems which would appear to us practically insurmountable if the bill, as now proposed, should be enacted into law.

May I say that what I have to say will not take very long, and I should be happy to have interruptions, if you choose to do so.

Senator HUGHES. Very well.

Mr. EATON. I am going to be rather personal in presenting this to you because our own business is the one that I really know about, but I am convinced that it is typical of a number of others in the industry. It seems to me that is the only way—through studying the application of the bill in specific instances—that we are able to appreciate its far-reaching effects.

We have been in business since 1924. At the present time there are 36 persons in our organization, that is, officers and others. Of this number, 30 were graduated from leading universities of the country, and 13 have studied in graduate schools. I mention this merely to give you some idea of the size or perhaps I should say, lack of size of our organization, and more particularly to suggest to you the type of personnel.

Our principal business, then, is to render investment counsel or investment management to persons whose accounts are of sufficient size to be handled individually. To take care of persons of moderate means desiring our service, we have established certain management funds—that is, we call them management funds—which are known to you as investment trusts.

As an organization, our personnel is, I believe, not only qualified to serve as investment counselors but also is well qualified to serve the investor of moderate means honestly, adequately, and economically through these trusts.

My firm would appear to be affected by the proposed law, both in regard to these management funds and also our general management and counsel business. For the present, I propose to discuss our problem from the trust angle alone, namely, title I, and with emphasis on a few of the difficulties which we would be forced to meet.

Different people naturally have different investment requirements. For example, the investment problem of a business man may be quite different from that of a person without earning power. To meet to some extent these different objectives, we now sponsor and manage two investment trusts.

The form of a trust with transferable shares has long been used in Massachusetts as a medium for investment. Its general characteristics have been described to you, juts now, by the previous witness, Mr. Curtis. One of the principal points of difference between such a trust and a corporation is that in the trust the control is in the management, as distinguished from the shareholders. It is also my understanding that the duties of the trustees of such a trust and the rights of the shareholders are generally spelled out through the trust instrument in greater detail than in the case of a corporation.

As Eaton & Howard, Inc., is not a trust company, it cannot in Massachusetts act as the trustee of the trusts which we have created. Therefore, certain of the officers of the corporation, as individuals, are the trustees. We do not want and we should not have any so-called outside directors or trustees. The management of the trusts is Eaton & Howard's responsibility, and the officers of Eaton & Howard seem to us the proper persons to serve as trustees. This is a point on which we feel very strongly and about which I shall speak later.

Let me tell you a few of the restrictions which our trust indenture places on the management:

The trustees, as such, may receive no compensation.

Senator Hughes. You are a corporation?

Mr. Eaton. Yes, sir; we are a corporation.

Senator Hughes. You are now a corporation?

Mr. Eaton. Yes, sir.

The compensation of our company, which sells the shares and manages the trusts, is limited to 6 percent on sales—one-half of 1 percent a year for management, and 1 percent on redemption. That is when a person withdraws his shares.

A shareholder may redeem his shares at any time. There can be only one class of shares outstanding. These restrictions are in our trust indenture.

The managers may not resign or withdraw except after 60 days' notice to each shareholder, thus giving him 60 days within which to redeem, if he objects to the proposed change of management.

The trustees and managers are prohibited from dealing with themselves as principals or from making any personal profit on transactions for the trusts—thereby eliminating, we believe, loans to officers and also eliminating other possible conflicts of interest.

Not more than 5 percent of the assets can be invested in the securities of any one company, and not more than 10 percent of the securities of any one company may be owned by the trust—thereby preventing pyramiding or control.

There is an absolute prohibition against borrowing; in other words, we do not borrow at all; and there is also an absolute prohibition against pledging or mortgaging the assets of the trust—thereby preventing buying on margin.

These are restrictions which we have imposed upon ourselves. They cannot be changed except with the written consent of a majority in interest of our shareholders.

In our opinion, these restrictions go beyond the requirements of the proposed law in preventing the abuses which have occurred in certain parts of the investment company field.

Senator Hughes. Excuse me just a minute, please.

Mr. Eaton. Yes, sir.

Senator Hughes. You imposed those restrictions on yourself, by means of a contract?

Mr. Eaton. They are a part of the trust indenture.

Senator Hughes. They are a part of the trust indenture?

Mr. Eaton. Yes, sir; they cannot be changed except by vote of the majority of the shareholders.

I have said that we believe these restrictions go beyond the requirements of the proposed law in preventing the abuses which have occurred in certain parts of the investment company field. Yet, what happens? In spite of this, in spite of the fact that we have eliminated the possibilty of most, if not all, of the abuses at which the law is directed, the proposed law would put our trusts out of business and would greatly restrict our operation along lines which we believe to be sound and in the interest of our clients. I can assure you, gentlemen, there are other trusts and corporations doing a comparable job, and which would be similarly injured.

I shall try now to show you a few of the ways in which this bill vitally affects us, and in this connection shall confine myself to the provisions relating to open-end management companies and, in fact, to those affecting diversified management companies within this group.

First, I should like to point out what I consider is a fundamental feature in the philosophy behind a so-called open-end company.

The open-end or mutual company is one in which a shareholder may at any time on short notice take his shares to the company and demand that they be redeemed at substantially their liquidating value. I have described how our investment funds or trusts were created to serve the investor with insufficient funds for us to handle as a separate account. The shareholder has, in effect, a diversified investment account under our management; he is the beneficiary of a commingled fund. In all our individual accounts, a client may terminate his management contract with us at any time. He may at any time decide to manage his own securities or take them somewhere else for management. To provide as nearly as possible the same

opportunity for a shareholder in our funds, we adopted this redemption feature which, in effect, says to a shareholder:

> For any reason, at any time, you may terminate the arrangement and have the liquidating value of your shares at the time, less a fee of 1 percent which represents an approximation of the cost of redemption.

There has been some talk in these hearings about control and there are many references in the bill to control by the stockholders. In my opinion, there has been in the past much loose talk and even sloppy thinking about the subject of control.

There is more than one consideration to this question of control. When an investor comes to us and buys shares in our fund—and right here I might mention that the average investment in our largest fund is over $5,000 per shareholder. I think those figures hold for the smaller fund, but I know these are correct figures in the case of our largest fund.

When an investor buys a share in the fund, whom does he want to control his money? Does he want it to be subject to the control of a majority in interest of those persons who happen to be at any one time the shareholders of the trust; or does he want us, whom he has selected to manage his property, to have control—subject, of course, to the restrictions placed on that control through our trust indenture, which includes his right of redemption? Does he want to have it possible for a group, alien to our management, by buying some shares to start a proxy fight and try to get control of his money, or does he want the assurance of continuity of management in those persons he has selected?

Bear in mind, please, that this investor, himself, has the right to change the management, by redeeming his shares at any time at their approximate liquidating value. It is our opinion that when he buys our shares he wishes the control to be in us, subject to his right of redemption; and the bill's provisions regarding limiting a management contract to 2 years, making it subject to annual approval, and making the directors or trustees subject to annual election, are entirely out of place and are uncalled for, when applied to an open-end diversified investment trust, and are based on a misconception of the underlying philosophy of such a trust.

I believe the commission recognizes that true control by scattered stockholders is difficult, if not impossible of accomplishment. Yet the control which a shareholder in an open-end trust has over his own funds, through the redemption feature, is a very real and valuable control. Since scattered stockholders usually vote the way the management requests, the provisions for voting by shareholders may not be regarded as objectionable to most of the investment companies appearing before you, and may not be strongly criticized. I do not mean that is the only reason; but they just may not criticize. We do.

However, gentlemen, please remember that it is easy for a person not affected by a proposed regulation to acquiesce.

I should like to put special emphasis on that point, because I may be doing it myself.

This subject of voting by shareholders is vital to us and to a number of others. Our attorneys advise us, as you have already heard—but I should like to mention it again—that if our trust permitted the annual election of trustees, as required by section 16, our shareholders would be regarded under Massachusetts law as partners and, as such, would

be personally liable for any debts or obligations of the trust—obviously preventing the salability of the shares. The shareholders not only would be surprised, but I would be surprised if we got any more shareholders. Of course, Senator, it was Mr. Curtis who spoke of the shareholders' being surprised.

Thus, sections 15 and 16 of the proposed bill would necessitate a complete reorganization of our trusts, and these sections probably would mean the dissolution of our trusts. The difficulties, expense, and confusion involved would be an unfair burden to our shareholders and to us.

To summarize briefly, continuity of management is something for which an investor naturally looks when seeking to invest his money. He derives a feeling of assurance from the realization that the persons from whom he purchases shares in a trust are responsible for the continued management of the trust and cannot get out of this responsibility without notice to him. The testimony before the Commission has disclosed the importance of not permitting a change to other management, which may be irresponsible, without adequate notice to the investor. The proposed bill, in this same paragraph 15, recognizes this danger and requires the termination of a management contract upon its assignment. We have no fault to find with this provision; but to require annual approval of, or permit the change of, management by a percentage of stockholders may, in our opinion, be bringing about a contrary result, in leaving management the football of a proxy fight to be thrown out by some unscrupulous group having no responsibility to the shareholders in the original sales of the shares.

I believe that the provisions requiring election of trustees and approval of the management contract are both unnecessary and unsound in principle; and in the case of an open-end investment company with redeemable shares, I believe that a provision requiring adequate notice before any change could be made in a majority of the trustees or in the management contract, would accomplish all that is being sought by these sections.

As I have outlined, our corporation organized our trusts, sells the shares—receiving a commission of 6 percent on such sales, and manages the trusts for a fee of one-half of 1 percent a year. This bill would prevent us from both selling the shares and managing the trusts. Thus, it would appear that selling the shares of a trust which you intend to manage is a vice. This idea, to my way of thinking, is ridiculous.

Here, again, I believe that some of the abuses indulged in by persons who were improperly representing the shares they were selling, and who were improperly managing the trusts whose shares they sold, have clouded the issue. We take a stand diametrically opposed to that premise which would separate sales from management. Unity of sales and management in one organization is, in our opinion, a virtue and a protection to the investor, rather than a vice. Our obligation to manage assures to the investor a continuing responsibility for the article which he has purchased. As sellers, we are vitally interested that the management is good and that the management costs are kept at a minimum. As managers, we are interested that the selling policy is sound and that the selling costs are low.

Thus, we avoid any risk of a temporary selling organization which may go out of business as soon as the profits from sales disappear.

Having given the trusts our name, we feel ourselves responsible, and we would refuse to permit anyone else to manage them. Conversely, as investment managers we have in more than one instance declined to manage a trust sponsored by others, because we would not have the power of control over the sales policy, which we consider so important.

Under an exception in the proposed bill, if we were merely advisers to the trusts and did not actually manage them, we could also sell the shares, provided our selling charge did not exceed 1 percent.

This exception for an investment adviser does not make sense to us, where it is provided that the sales load may not exceed 1 percent. If our principle is sound—and we believe it is—that the selling of the shares by the same organization which manages the trust is a protection to the investor, then why should the selling commission be limited so that such an organization is virtually put out of business by being limited to a commission at which one cannot afford to sell, and being in competition with other trusts whose selling commissions are unlimited, under the bill?

High-grade, honest salesmanship is one of the greatest assets in our national economy. I personally believe in it. Why penalize the type of organization which, from its very set-up in having to manage the funds whose shares it sells, is likely to use the most conservative sales methods? Yet, that is exactly what this separation does. If there had been more sales of shares of the type of companies for which I speak, the losses to investors, through the abuses about which you have heard, would have been greatly reduced.

May I record here a conviction that I have held for at least 15 years—that is, most of the time I have been in business; namely, that if an adequate selling commission had been placed on good securities, rather than on the poorer securities, the average investor would never have had such grief as he has had in recent years.

I, as an investment counselor, and individually in connection with such organizations, have seen many lists where the proverbial Susie Jones has owned five bonds of an issue where the seller has obviously obtained $50 to $100 commission, and one bond where the seller has obtained $10 commission. I am thinking of lists that go back over a period of years; and had that been reversed and had the selling commission been equalized, then I do not think that would have happened.

I believe the provision requiring the separation of the selling of open-end investment trusts from management should be eliminated. I believe that if there is to be a provision exempting trusts which are run by investment advisers, it should be extended to include investment managers as well; and I further believe if there is to be such an exemption, there should be no discrimination against such trusts, in the form of a limitation on the selling commission.

The next point I want to touch upon is the matter of conflicts of interest. The title of section 10 of the bill reads: "Affiliations involving conflicts of interest." It apparently is aimed to eliminate those abuses which are referred to in paragraph 2 of the declaration of policy of the bill—namely, cases where investment companies are organized or managed in the interest of others than the shareholders of the company.

The section apparently is intended merely to give legal sanction to the fundamental law of morals "that no man can serve two masters." We have no quarrel with this general proposition—in fact, as investment managers, we were to a very real extent pioneers in the application of this principle to the investment field. Therefore, we are and always have been strongly in favor of it.

In our own case, our trust indentures have always provided—now I am going to quote:

The trustees and the managers covenant that they will not deal with themselves as principals in making purchases or sales of securities for the account of the management fund.

They contain the further provision that no trustee or manager may accept any commission in the purchase or sale of securities for the fund, or—and here I quote again—

make any profit on any transaction for the management fund either directly or indirectly whether as a member of any partnership, association, or corporation or otherwise.

Yet, this legislation, designed to prevent dumping of securities by insiders, improper and fictitious transactions between investment companies of the same system, and other similar abuses, would require drastic changes even in a set-up such as ours, where any form of self-dealing by the affiliated parties has always been prohibited.

This section 10 says that we cannot sell the shares of the trusts we manage. I have already dealt with the reasons why I consider this unsound. It further says that a majority of the trustees cannot be connected with the management company. But why? I have already explained why we picked the officers of Eaton & Joward, Inc., to be the trustees; and why are they not qualified to serve as trustees? They receive no compensation. They cannot profit from transactions for the trust. They devote full time to the job of serving the investor; but we are told we must have outside trustees—presumably to protect the investors.

One of the witnesses here spoke just this afternoon in favor of outside directors, as a cure for self-dealing. I do not entirely agree with what was said. In certain situations an independent board may be desirable. I am not sure that I know just what the terms "outside directors" or "independent directors" imply; but I do say that if self-dealing is already prevented or if the only interest of the directors is to serve the shareholder in the trust, then in these instances I personally think that the witness went too far in his remarks about outside directors. However, from my remarks I think you will see what I mean.

In any case, I think the witness referred to this suggestion as a cure for a nonexisting disease; and this is certainly so in our case.

Senator Hughes. But is it so with respect to other companies?

Mr. Eaton. What is that, Senator?

Senator Hughes. You say it is so in your case?

Mr. Eaton. Well, I have taken our case; and I know that, in general and in great part, I am speaking—not formally, but informally—as a representative of a good many small trusts.

Senator Hughes. But you know the business generally, I presume?

Mr. Eaton. I have been in it quite a while, sir, primarily as an investment counselor and manager; and we have been managing our funds for a good many years.

However, the case for outside directors does not appear to be strengthened by the testimony of some of the Commission's witnesses in this hearing. Judge Healy on the first day referred to Mr. Charles A. Kettering as one of our finest and most useful citizens, who was a director of an investment company. Mr. Kettering testified before the Commission that he had been unable to attend meetings, he did not understand investments, and that he "saw life through the laboratory window."

Again, Mr. Stern, in describing the American Founders fiasco, referred to the fine research and investment department and testified before this committee:

> Then there were other things that were for the protection of investors. There were some fairly big names as on the directorate. The directors on the whole—a great many of them—just did not know what was going on. * * *

That, I can assure you, is not true of our trustees. They are there every day.

I am not suggesting that anyone who wants outside directors should not have them; but if the purpose is to prevent self-dealing and to insure the management of the trusts in the interests of the shareholders, then to require outside trustees in a case such as ours, where self-dealing is already prohibited, is certainly not necessary.

I would not object to having in the bill a prohibition of self-dealing. In fact, I do not object to most of the professed purposes of this bill. What I object to is its marksmanship in hitting so many innocent bystanders in the battle between the Securities and Exchange Commission and certain crooks who crept into a division of the investment company industry, which is no closer to us than a second cousin.

Another matter in which this bill would affect us and, we believe, would injure our clients is in the prevention of any investment manager from managing more than one trust. We can see no reason whatsoever why either we or any other investment management organization should be restrained in regard to the number of funds managed. Over a period of years we have had experience in managing funds; and in no instance have we been conscious of the slightest conflict between them. Also, Senator, one has not been handling bonds and the other one handling stocks, either.

In no instance to our knowledge has there been any occasion where one has suffered because of the existence of the other. On the contrary, there is in our opinion excellent reason why we should be free to manage funds which have different purposes and policies; and the occasion may very well arise when it would be advisable to manage more than one fund with the same purpose and policy. If, for instance, the tax laws were changed in certain directions—as might at any time be the case—then we can visualize a situation where it would be to the advantage of the small investor to have his money managed with others in units which were not too large.

Today, there are sufficient reasons why an investment manager should be allowed to manage more than one fund; and it is possible that the future may further justify, or even make necessary, the management of more than one fund.

To restrain the investment manager in this respect would, to our way of thinking, be no different from forcing a trust company to divest itself from the management of all trusts except one.

It may be of interest to mention the fact that several of the more fully established investment counsel or management firms are numbered among those organizations which have established more than one fund. Such a development has been a natural one, consistent with the policy of managing money for clients in accordance with a purpose and investment policy designed to meet the needs of that particular person.

Is it not the case that such a development as managing funds with different investment objectives by investment counsel organizations is backed by the logic of the situation, as well as by those organizations that, by the very nature of their professional approach to the subject of investing, are well suited to take the investor's point of view?

We believe this to be the case, and we also believe that such organizations are making every attempt to look after the best interests of such investors. Moreover, we know that funds managed by organizations where more than one fund has been under their care, have to date shown a satisfactory investment performance. I do not have any figures to support that statement; but if such figures would be of any value to you, I can submit them for the record.

Therefore, unless the Commission can see good reason why a firm of investment managers should not manage more than one fund or trust, we urge that there be no recommendation to Congress which might, in any way, restrain the development of a method of aiding the investor of moderate means. We feel that it would be counter to the public interest to interfere with the development of management funds managed in an effort to accomplish different investment objectives just at a time when, fortunately, an increasing number of investors of moderate means are becoming educated to the wisdom of such procedure.

During the half century just passed, the investor of moderate means has been handicapped by the service he has or has not received. Nobody doubts that. This certainly has not been entirely the fault of many of the people in the security business. It has been largely due to the system itself, combined with the weaknesses of human nature; and these are matters which in my opinion must be taken into consideration by this committee.

The last decade has witnessed the constructive development of an industry which has made real progress in coping with this serious problem. That development has taken the form of investment trusts—some of which, as I have indicated, are being sponsored and managed by investment management or investment counsel organizations.

This is, indeed, no time to handicap a movement which is so essentially constructive. To segregate control, management, and selling, and to restrain the number of trusts to be managed by any one organization, would strike a blow at us and others like us, and at our respective clients. The extent of the consequences of such a blow is not possible to foresee.

I believe sincerely that if such a blow were struck, it would be entirely unjustified and would strike at the heart of a wholesome development in the investment field at a time when its value is only beginning to be recognized.

I further believe that this bill would be a blow to the very investor it is designed to serve, because the enactment into law of this bill would result in putting out of business and out of the industry some

of those elements which constitute the investors' greatest protection.

In closing, may I quote two sentences from an article which a lawyer friend of mine showed me, written by Mr. William O. Douglas, former chairman of the Securities and Exchange Commission. The article was dealing with the subject of correcting, through legislation, certain abuses in the business system. In discussing such possible regulatory legislation, this is what the now Mr. Justice Douglas said:

> Our remedies should not be as hysterical as the practices which made the demand and need for regulation insistent. * * * It is a rebuke to our skill and judgment if we cannot effect competent police measures without driving from the field of enterprise the men of greatest competence and substance.

Thank you, sir.

Senator HUGHES. It seems to me that the Justice's judgment was very sound.

Mr. EATON. Yes, sir.

Senator HUGHES. And it usually is.

I wondered if I might say that I am sure the committee—although I am speaking personally—would invite from any of the persons who appear here to testify a draft of a bill which you think would cover all the needs of the occasion. Most of you recognize that there are some features of this legislation that are necessary, and that we do need something.

Mr. EATON. Yes, sir. We also recognize that drafting such a bill is most difficult.

Senator HUGHES. Yes; I judge that is so. I have tried my hand at it for forty-odd years, and I did not make any great success.

However, I say the invitation is out for any of you who see the situation in that way to approach the matter. It would help us.

Mr. EATON. We shall try to help. Many of us would like to help.

Senator HUGHES. Thank you. Does that conclude your remarks, Mr. Eaton?

Mr. EATON. Yes, Senator.

Senator HUGHES (presiding). We shall not hear any more witnesses today, as I understand.

Tomorrow we shall start at 10 o'clock, and we shall continue until 12 o'clock or perhaps a little longer; but you must remember that our colleagues have adjourned until Monday and that they will be going ahead to catch up with the work in their offices; and Senator Herring and I need an opportunity to do our office work, too, you understand. So I think we shall stop tomorrow at noontime.

(Thereupon, at 5:10 p. m., a recess was taken until tomorrow Friday, April 19, 1940, at 10 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

FRIDAY, APRIL 19, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10 a. m., in room 301, Senate Office Building, Senator James H. Hughes presiding.

Present: Senators Hughes (presiding), Herring, and Downey.

Senator Hughes. The subcommittee will come to order. Mr. Myers, I alone will hear you until some other members of the subcommittee come in.

Mr. Myers. I thank you.

STATEMENT OF JOHN SHERMAN MYERS, NEW YORK CITY; VICE PRESIDENT OF LORD, ABBETT & CO., INC., PRESIDENT OF AMERICAN BUSINESS SHARES, INC., AND VICE PRESIDENT OF AFFILIATED FUND, INC.

Mr. Myers. Mr. Chairman, my name is John Sherman Myers. I have been closely identified with the investment trust business for more than 12 years. At the present time I am vice president of Lord, Abbett & Co., Inc., the sponsors of two open-end investment companies; Affiliated Fund, Inc., with assets of approximately $25,000,000, and American Business Shares, Inc., with assets of about $7,000,000. I am president of the latter corporation and a vice president of Affiliated Fund, Inc. I am also president of North American Depositor Corporation, which is the depositor company for a number of fixed or unit-type investment trusts, with assets totaling some $20,000,000. You will thus see that the assets under our control, shall I say, approximate some $50,000,000.

I am appearing in opposition to S. 3580, the investment-trust bill. I am not here to oppose constructive, realistic, and uniform regulation—if that should be the will of the Congress. But I am opposed to this or any other bill that fails to consider the practical side of this business and puts it, in all of its phases from formation to liquidation, under the domination of the S. E. C.

Mr. Chairman, I would like, with your permission, to insert in the record my complete statement. I will have the time to discuss only a few points that are contained in this statement, but if I may have your permission to have the statement in its entirety made a part of the record, I will appreciate it.

Senator Hughes (presiding). Have you furnished a copy of your statement to the committee reporter?

Mr. MYERS. Yes, Mr. Chairman, a copy of my statemen[illegible]een furnished to your committee reporter.

Senator HUGHES. Your request is granted.

Mr. MYERS. I would like, at this point, to interpolate one observation: A number of people have talked about the highly discretionary powers the Securities and Exchange Commission are given under this bill. No one, however, has attempted to bring them all in at one place. I am not going to repeat any more than I can help; and I do want the S. E. C. to appreciate that I am talking, not with a finger pointing at the present Commission or at any representative of that Commission; I am speaking purely objectively, and when I criticize the S. E. C. it does not mean I am pointing my finger at any of my friends, if I may use that word, that I have in that body.

I do not believe that it is contended that the bad practices described to you are by any means typical. Generally they have not existed in open-end companies. We constantly strive for improvement and are eager for suggestions from any source that will have that effect. Dishonesty and malpractice, however, are inherent in human nature and cannot be eliminated by the simple expedient of an act of Congress. If the existence of fraud, dishonesty, and chicanery are to be the base for Government regulation of investment companies, then all business needs Government regulation. Some instances of dishonesty and abuse will be found in every activity of mankind, including politics and the law.

If too much emphasis is placed upon abuses, upon lootings, and upon plunderers, the result may well be that the ordinary people in the investment-trust business—and the testimony so far presented to this committee admits that there are some honest ones left—will be unduly hampered in the administration and management of their companies. There would be no reckless driving if automobiles were abolished. There will be no lootings of investment companies if it is made impractical or unprofitable to operate them.

You have been told that in our earlier conferences with the S. E. C. we were able to discuss only general principles; no representative of any investment company saw this bill until, with the rest of the public, we were able to read the printed copy after it was introduced.

I must add that some of the proposals outlined to us are not in the bill, and I like to believe that our discussions influenced these omissions.

I must emphasize, however, that there have been inserted in the bill a number of important provisions not among the proposal discussed and which were never mentioned by the S. E. C. Needless to say, these new provisions include some that would have been vigorously discussed had we known that they were contemplated.

Judge Healey has said that the S. E. C. made known its willingness to discuss the details of the bill with representatives of the industry after it was introduced, and regretted that the industry did not see fit, with a few special exceptions, to accept that invitation. I was one of the few special exceptions. Time did not permit anything like an adequate discussion. Furthermore, the magnitude of the regulation of our business, which the bill contemplates, going far beyond anything that I could endorse as the basis for a realistic, practical, and constructive regulation of investing companies, made me believe that it would not be possible to modify the bill prior to these hearings to the degree necessary to merit endorsement by the business. After

the hearings are over I hope to take advantage of the Commission's willingness to discuss the bill and to go into it with them in complete details.

One of the most important objections to this bill, as a whole is the extraordinary power over nearly all phases of the formation, capitalization, operation, and even liquidation of investing companies, as well as the distribution of their securities, that it gives to the S. E. C. We must not forget that the S. E. C.—which will administer this bill—is its author. As an administrative or law-enforcing body the S. E. C. may be expected to be concerned with irregularities, violations of the law, and easier ways to enforce its penalties.

Of course, the easiest way for the administrative body to accomplish this is to obtain discretionary power in every possible connection. "Let us," says the S. E. C., "decide ourselves what is best to do in any set of circumstances. Give us the authority to fill holes in the bill by making rules; by making regulations; by issuing orders; by acting on application of an interested party; by acting on our own motion. Give us power to add here and take away there."

The administrative body naturally must be given a certain amount of discretion in the administration of a bill of this nature. A certain amount of flexibility—Judge Healy called it "rubber"—is essential. But there is a difference between discretion of that nature and the kind of discretion that appears throughout the bill.

I will be able to discuss only a few of the substantive discretionary powers that the S. E. C.'s own bill gives to the S. E. C. Not all of them, because, by actual count, there are some 80 or more clauses in the bill that gives the S. E. C. the power to do something or other. About 50 of these are of a substantive nature and only 30 are administrative.

The bill classifies investment companies, and subclassifies the management companies. Then the Commission, section 5 (d), asks for authority to make further classifications or subclassifications according to (1) organization, (2) capital structure, (3) nature of assets, (4) amount of assets, (5) investment policy, and (6) character of business done. These are perhaps not unreasonable guides, although they would permit a wide discretion in subsequent classification. But then come the following words:

or any one or more other characteristics which the Commission deems significant.

The practical effect of this catch-all clause removes whatever limitation may have been imposed by the earlier guides or standards. The power "further to classify" has no limit other than that of the S. E. C.'s own judgment.

Taking into consideration this section with the other provisions of the bill, the Commission, as a result of its power further to classify, obtains the right to prescribe a different form for each classification, as well as the scope and content of the reports filed by trusts in each classification. Numerous other powers could be so exercised by the Commission as to stifle the operations of any particular company, the character of whose business the Commission for any reason did not like. This goes far beyond mere regulation necessary for the protection of investors.

When I had an opportunity to examine S. 3580 carefully, I was surprised to learn that in section 6, subdivision (c), the Commission,

on its own motion or on application, may conditionally or unconditionally exempt any person, any security, or any transaction from any provision or provisions of the bill, or from any rule or regulation.

I cannot conceive of the law which will contain a provision giving to the bureau entrusted with its administration the power to pick and choose those who will come under its provisions—or even the right to select those who will be exempted from certain of those provisions. Here the "rubber" can be used completely to erase the effect of the bill on certain companies.

Please note that section 3, paragraph (b) and (c), expressly exclude certain companies from the definition of an investment company. An interesting question arises as to whether the power of the S. E. C. to exempt companies from the provisions of the bill includes the power to exempt them from the operation of these exempting clauses. Perhaps this was not intended, but I believe the bill may well be subject to that interpretation, particularly if it ever seemed desirable to reach that result in any given instance.

This is not as improbable as it seems, since the power to bring a specifically exempted company back under the provisions of the bill is expressly requested by the S. E. C. in section 6. This section says that a foreign investment company is exempt, that a company organized in the territories of the United States not offering securities is exempt, that a company in bankruptcy is exempt, that an employees' securities company may be exempt if the S. E. C. so orders. But in subsection (d) it is expressly provided that the S. E. C., if it wishes, may make each of those exempted companies subject to the provisions of the bill "as though such company were a registered investment company."

Putting these sections together we find the S. E. C. in its own bill to regulate investment companies, asking for the discretionary authority nevertheless to excuse certain people and companies and transactions from the provisions of the bill on the one hand, and, on the other hand, discretionary power to recapture the authority over such companies as may have come under the exempting clauses.

I submit that this bill means (1) that an investment company is what the S. E. C., in its discretion, says it is; (2) that this bill shall apply to such investment company or companies as the S. E. C. in its discretion may determine; (3) that this bill shall not apply to such investment companies as the S. E. C., in its discretion may decide to exempt.

Under section 8, the Commission, with apparent reasonableness, asks authority to prescribe the form in which certain material must be filed in connection with the registration of investment companies. However, the section also would give the Commission the right to require, in addition to certain specified information, any additional pertinent information (the S. E. C. to decide what is "pertinent") regarding the investment company, all persons connected with it, and the underwriters of its securities. One of the great objections to the administration of the Securities Act of 1933 is the voluminous, burdensome and costly requirements applicable to the registration of securities. All of the Commission's authority under the 1933 act is incorporated by reference in the new bill, and, in addition, we find the clause regarding "all pertinent information," which I have just described. The requirements for registration of an investment company could be made terrifically burdensome.

In section 11 the bill deals with the recurrent promotion of investment companies, i. e., no promotion of more than one new trust in any 5-year period, etc., a subject covered very well by Mr. Adler. Subdivision (d), however, would permit the S. E. C. in its own discretion to nullify this section as to given persons by exempting them from its operation.

This, of course, is more of the same latitude I have just described—the bill containing certain prohibitions and the S. E. C. asking power to deal out exemptions. But here the significance is even greater, since the prohibitions apply only to persons identified with investment companies who start new companies. Of course, I feel that this prohibition is completely wrong in substance. Under it, those who are inexperienced and who have had no important connection with investment trusts, may go right ahead and ask the public to participate in a new venture. The experienced trust people are barred—unless the S. E. C. sees fit to drop the bars. The prohibition, plus the power to exempt, results in complete S. E. C. authority to decide what, if any, new trusts will be formed if experienced trustmen participate in the formation.

The practical result is this: If the men in the investment company business have conducted their affairs according to the S. E. C.'s idea of what was sound and right, and if the S. E. C. finds no ulterior purpose in the promotion of a new company, and if the new company meets the S. E. C.'s then conception of what is desirable in investment company set-up and theory, then the S. E. C. can let them go ahead. The lack of restriction on the new promoters may be likened to the old common law adage that every dog is entitled to one bite. Until a given individual gets into the business, no one knows whether he will bite or not.

My difficulty with this sort of power is that the S. E. C. itself asks to be the final judge on this question. There is, I think, no appeal from a refusal of the S. E. C. to act under the exempting clause, and if there were, the Court might well hold that the judgment of the Commission on such a matter as this, under the bill, is final.

In section 13 (b) the bill presents what appears to be a reasonable requirement—that no investment company "shall change any fundamental investment or management policy" except by vote of its shareholders. But the reasonableness of this provision is nullified by the very next sentence in the paragraph—where the S. E. C. asks for the right to "designate those investment and management policies which are fundamental."

The possibility of arbitrary rulings or of erroneous conception of the S. E. C. of what is fundamental, the unchangeable fact that the company itself, through its management, is the only one who should decide such matters, and that it must be in a position to act quickly, all make this power highly undesirable.

I am not in favor of an investment company suddenly selling its listed securities and beginning the operation of a South American subway. But I am violently opposed to being compelled to accept whatever the S. E. C. may label "fundamental" in the operation and management of an investment company. Frankly, I do not believe the Commission or anyone else can adequately define these fundamental policies. Some of them, like the subway, are clear. But hundreds of others will fall within the twilight zone, and even after the S. E. C. defines them we will still be going to the S. E. C., saying

"We want to do this. Is it fundamental—may we do it without going to our stockholders?"

Under section 17 (g) the Commission asks for authority by rule, regulation, or order, to require that an investment company utilize the services of a bank as custodian, and that officers, and so forth, and so forth, be bonded by a fidelity insurance company, in such minimum amount as the commission may prescribe. The provision should be heartily endorsed by banks and insurance companies. The S. E. C. will be a prolific source of business for these concerns, at the expense of the stockholders of investment companies. This is peculiarly an internal matter for the management and for the stockholders. At the very most, the requirement should be, instead of permitting the S. E. C. to decide the matter, to require it to be submitted to the shareholders with information on the need of the proposal and with full data as to its cost. Personally, I believe in the use of a trustee or custodian, and in the bonding of employees, but that is a matter that each company should decide for itself and should not be the subject of S. E. C. discretion.

Senator Hughes. If you will pardon me right there for a moment: As I understand you, you are opposed to the power in the S. E. C. to designate depositaries or to require that funds be deposited with a bank or certain banks?

Mr. Myers. That is perfectly correct.

Senator Hughes. And you think that power should be left entirely to the investment trusts?

Mr. Myers. I tried to make this point: That if the S. E. C. should find in a given instance it is desirable that a given company should utilize the services of a corporate trustee or a corporate custodian or a bank trustee or a bank custodian, the very most that the S. E. C. should be permitted to do is to require a submission of the question, with data as to the reasons, and as to the cost thereof, to the stockholders of the company for them to decide how they want their assets handled.

Under section 18 (d) the commission asks that, upon application by any holder of any security of an investment company, it be required, and on its own motion be permitted, to make the company take such steps as are necessary or appropriate "to effect an equitable redistribution of voting rights and privileges among the holders of the outstanding securities." This is to take place after 2 years. Note that the application may be made by any holder of any security—a broad invitation for strike actions against investment companies with nonvoting securities. The provision apparently was intended to apply only to investment company systems and not to individual companies. But I believe, as, I think, does Mr. Schenker, it is possible so to interpret it that it will affect any company with nonvoting securities outstanding. I have no doubt that some attempt will be made by the instigators of strike suits to make it so apply.

This subject has been adequately discussed by representatives of the closed-end companies, and all I want to do in this connection is to point out that in many cases the question of the vote is something that is covered by the charter of the investment company concerned, and I cannot conceive of a method by which the S. E. C. can effectively make the holders of voting control voluntarily vote to amend the charter of the company in order to accomplish this equitable redis-

tribution of voting rights. But the subject, as I say, I think has been adequately covered.

The provision gives the S. E. C. the right to abrogate the terms of the contracts under which all senior securities were issued and are now outstanding, and, what is worse, the S. E. C. asks the right to enforce, in the face of those contracts, the S. E. C.'s own idea of what is an "equitable redistribution of voting rights." It involves matters that are embodied in corporate charters, changeable only by stockholder action. The S. E. C. apparently expects the holders of the voting stock voluntarily to give up a portion of their voting rights. But suppose they won't? How will the S. E. C. make them vote according to its idea of what is equitable?

Before taking up the authority of the S. E. C. relating to dividend payments, I should like to point out that Mr. Smith gave testimony about what he called dividends paid out of capital. He gave the impression that section 19 (a) of the bill dealt with the payment of dividends out of capital.

The provision goes far beyond this. I could understand a restriction merely against distribution of capital in the form of dividends, but this section puts the same restriction upon the payment of dividends out of profits.

If a company has sold securities at a price higher than cost, it realizes a profit by so doing, and this bill actually provides that the net profit so realized may not be distributed except under the same restrictions that apply to distribution of capital. This is in the face of a provision in the revenue act that a mutual investment company must distribute to stockholders at least 90 percent of its taxable income, or lose its tax advantage. Net profit realized as described, is, of course, taxable.

Section 19 (b) of the bill goes even further: It prohibits the payment of any dividend, irrespective of its source, if the company has senior securities outstanding, unless certain asset coverages exist. The coverage required in connection with senior stock is 200 percent, but the Commission asks for the right to increase this coverage up to 300 percent or to reduce it to 150 percent. If the senior securities consist of evidences of indebtedness, the asset coverage is 300 percent, which the Commission is permitted to increase to 400 percent or to reduce to 200 percent.

It is difficult to conceive the basis for requiring such large asset coverage for senior securities before dividends can be paid out of earnings, net profits and earned surplus. Were the prohibition on distribution of capital in the form of dividends, it would be more understandable, but to prohibit dividends out of income and profit after interest charges and other expenses have been met, seems more than a trifle harsh. The concession that, under this bill senior securities, although prohibited in the future need not now be retired, is of no practical value if the bill, in effect, prevents the payment of dividends on the common stock. However, even if one should feel the prohibition desirable, it goes beyond reason to permit the S. E. C. to stiffen the basic coverage figures. Any company would be better off knowing what it had to face with certainty, without the fear that its policies might be interrupted.

Here, again, there is too much opportunity for the S. E. C. to establish by dictation its own ideas relating to dividends. This is some-

thing that should first be covered by the terms of the contract under which the senior security is issued, and secondly by the management of the company exercising its discretion in this purely internal company policy.

Under section 22 the S. E. C. asks that an open-end company be prohibited from selling, redeeming, or repurchasing any of its securities except at a price bearing such relation to the asset value as the commission shall prescribe by rule, regulation or order. The stated purpose for putting such power in the Commission is the elimination of dilution or accretion in the value of other securities of the company as a result of such sale, redemption or repurchase. This would mean that the Commission would obtain complete power over all methods of open-end companies of determining the asset value, the sale price, the bid price, or the redemption price of every security issued by any such company. This includes the right of the Commission to insist that its own methods be used, whether they are practical for sales purposes or not.

This was a subject discussed by Mr. Traylor, and I think completely discussed. I agree with everything he said in that connection.

In the same section the Commission asks power, if it "has reason to believe" that a security of an open-end company is being offered at a price which includes "an unconscionable or grossly excessive sales load," to hold a hearing and to require the company to show cause why the load should not be prohibited. And if, after the hearing, the Commission thinks this is so, the Commission may issue a so-called cease and desist order. The bill gives certain guides to the Commission in determining whether a load is excessive. There might be little real objection to these, even though they enable the S. E. C. to impose different standards on different companies. But the section then asks that the Commission be allowed to give attention "to such other factors as are relevant in the particular proceeding." This adds immeasurably to the scope of the commission's authority. There is, of course, basic objection to the idea that profit in sale of investment-company securities—the sales load or commission is the profit—should be put under the control of a government body. Remember that the amount of the sales profit is fully revealed in the prospectus of the company under the Securities Act of 1933. The S. E. C. should not distrub a completely publicized selling commission. The amount is fully controlled by competition and cannot be successfully influenced by artificial means. This business is not a quasi-monopoly, and to adopt this provision might be the first step in Government control of the profits of all business.

The control over the distribution of shares of open-end companies has been emphasized, since it is they who are currently selling securities. But some control extends to closed-end companies, which, under section 23, are brought under the domination of the S. E. C. by giving it power to make rules—

> to prevent or limit issuance * * * at a price below the current asset value.

The securities of a great many closed-end funds have a current market below asset value and, until this market situation is corrected, the Commission would be permitted to ban absolutely the sales of stock by such closed-end companies.

I omit discussion of the power the Commission asks over the form and content of prospectuses, over unit-type trusts, periodic-payment

plans, and face-amount certificate companies, and go directly to section 30, which relates to periodic reports. The apparent reasonableness of the section is destroyed when it is realized that the reports may be required not only from the company, but from the manager, investment adviser, underwriter, depositor, and distributor.

A distributor, as I understand it, means every dealer in the country who sells a share of stock.

They may include "such annual, semiannual, quarterly, and other periodic reports" as the S. E. C. may ask and the filing of "the minutes of such directors', stockholders', and other meetings", as the Commission may prescribe.

The Commission may require, if it sees fit, that any or all of this material filed with it also be sent to stockholders.

No one has advocated complete disclosure to stockholders more strongly than I, and my companies go the limit in this direction, but there should be some limit on what the S. E. C. may require to be furnished to stockholders.

Section 30, paragraph (a) requires every company, underwriter, broker, dealer, adviser, and so forth, to make up and keep, for such periods as the S. E. C. may prescribe, such accounts, cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may require.

Paragraph (b) states that all records thus required to be kept, or which may be kept voluntarily, are subject to periodic, special, and other examination by the Commission or any representative of the Commission. Under this provision the S. E. C. will always be at the elbow of every investment-company officer and employee.

Paragraph (c) gives to the Commission—in case it hasn't already been given the authority—the power at any time to make an examination of all the affairs of an investment company. This repeats the wide latitude just described.

Paragraph (d) covers actual accounting, giving the S. E. C. the power we have heard about to establish uniform accounting methods. It covers all possible transactions and at first blush sounds reasonable. But in paragraph (e) we find that the S. E. C. may prescribe the account in which any item whatsoever shall be entered and the manner in which the entry may be made; to require that any entry be modified or supplemented, and to prohibit the keeping of records in a manner other than that prescribed by the Commission.

On top of all this, under section 32 relating to auditors, which are voted upon by stockholders, the S. E. C. may prescribe the minimum scope of, and the procedure to be followed in, any audit. This is repeated in section 30 (a) where it is required that financial statements filed with the Commission be audited and be made and filed at such time and in such form or detail as the Commission shall prescribe. Then independent auditors must keep "reports, work sheets, and other documents and papers" and make them available to the Commission or any representative. The company and its stockholders pay the auditors, but the S. E. C. tells them how to do their work and insist that every detail of that work, no matter how preliminary, be made available to the S. E. C. Work sheets often contain material which is never even seen by the client. They have always been regarded as the property of the auditor rather than the client. The investment-trust bill thus assumes regulatory power over even the

independent auditor who works for an investment company. I hope, before these hearings end, some accountant or association of accountants will express an opinion on this.

Under section 36, the S. E. C. gives itself full and unrestricted power to make rules "necessary or appropriate" to carry out the bill. The rule-making authority over investment companies is as full and complete as human ingenuity can make it. Judge Healey's "rubber" has been stretched to cover the business completely.

In section 38, and this is the last section I intend to discuss, we find the usual authority for fishing expeditions, giving the Commission discretionary power to investigate anything it deems necessary or appropriate in order to (*a*) determine whether any person has or is about to violate the law; or (*b*) aid in its enforcement; or (*c*) to help in making rules; or (*d*) to obtain information to serve as a basis for recommending further legislation.

I should like to point out, too, that this continued investigative authority, which I believe was doubtful under the Public Utility Holding Act insofar as it applied to investment advisers and investment counselors, is now cured and the extended authority now specifically applies to a continuance of the investigation of investment advisers and investment counselors, since section 38 is incorporated by reference in the title of the bill.

The 4½-year study of investment companies—the cost of which was asked Mr. Schenker by Senator Townsend during the early days of these hearings, and which has been stated to be $581,000 up to April 1, not including another half-million cost to the trusts—is authorized to continue indefinitely. The section states:

> The Commission, in its discretion, may investigate any facts, conditions, practices, or matters, which it may deem necessary or appropriate * * * in obtaining information to serve as a basis for recommending further legislation concerning the matters to which this title relates.

This continued investigation now expressly applies to investment advisers, since this section is incorporated by reference into title II of the bill.

In conclusion. It has been impossible to consider all of the fifty-odd discretionary powers asked for by the S. E. C. in the bill. Only a few of the more significant could be treated at all, and the time available has not permitted a full discussion of any one of them. The omission of any provision does not mean there is no opposition to it.

I realize, of course, that many of the discretionary powers given to the S. E. C. in this bill would be burdensome to investment companies only if the S. E. C. should act arbitrarily or unreasonably. I don't say they will. Frankly, I don't know, whether the present Commission would or not, the Commission is subject to change in its personnel and necessarily, in its investment philosophy. The point is that the S. E. C. has the power to be unreasonable. That power should be minimized.

I thank you for your attention.

Senator Hughes. Might I ask you a question right there?

Mr. Myers. Certainly, Mr. Chairman.

Senator Hughes. Am I to understand that your objection goes to all discretionary powers provided for in this bill?

Mr. Myers. That is too broad a question to be answered in a word. I have already taken the position that there are necessarily dis-

cretionary powers which an administrative body must have for efficient administration of a bill of this character.

But the difference is between that kind of discretion and the wide-open discretion that this bill, in some fifty instances as opposed to some thirty instances of what I call administrative discretion, gives to the S. E. C. that cover formation, operation, management policies, and so forth, of investment trusts that take them from their birth to their death.

Senator Herring. Mr. Myers, as I came into the room you were discussing the subject of payment of dividends. You do not wish to be understood as objecting to the prohibition of payment of dividends from capital, do you?

Mr. Myers. Senator Herring, there is a good deal to be said on both sides of that question.

Senator Herring. I am speaking of capital now and not capital gains.

Mr. Myers. So am I, sir. I think there is something to be said for the theory that in many instances continuity of income is desirable. Let us assume that a company has a substantial amount of realizable capital gains. It is at a time when the management of the company thinks it would be desirable to hold their invested position rather than to sell in order to realize those gains to stabilize the dividend rate. That is, a dividend rate well within what experience indicates the company can pay. I think in a situation like that it is perfectly proper for a company, if I might use the expression, to borrow from its paid-in surplus account—subject, of course, to State law restrictions on the extent to which paid-in surplus can be used. There are such State law restrictions, but to borrow from its paid-in surplus for the purpose of stabilizing dividends.

I know of one situation where that took place and where by the end of the year realizable profits had come into the till to an extent sufficient to enable the company to pay the money back.

Senator Herring. Oh, yes; if they guess correctly, all right.

Mr. Myers. I think a great deal depends upon whether the stockholder knows what he is getting. It will be contended, I feel sure, that many stockholders do not know, even though you tell them, that because a payment comes in it is from, shall we say, paid-in surplus or capital surplus. I think, however, that may stockholders do know it, and I know that where paid-in surplus has been so used for dividends the effort of the S. E. C. has been to advise stockholders of that fact.

There is much to be said on both sides of the question. I know that there are arguments on the other side, and I am perfectly willing to give weight to those arguments. It is not a clear question and is not something I would be willing to answer categorically. I do say, however, the prohibition in this bill which puts restrictions on the payment of realized profits, on capital gains, is fundamentally wrong.

Senator Downey. To what extent can investment trusts have debts?

Mr. Myers. To the same extent, I think, as any corporation, Senator Downey. It is determined purely and simply by the powers that a corporation has under its charter to borrow money, through the issuance of debentures, or bonds, short-term loans from banks, and so forth. Most open-end funds have distinct restrictions on the

amounts borrowable. In the case of Affiliated Fund, Inc., one of the companies I am interested in, there is no power to borrow money except through the issuance of debentures, and the debentures are issued under a highly restrictive trust agreement, and I mean trust agreement.

However, my associate, Mr. Lord, who follows me, will discuss the debenture end of our company. We are not permitted under any circumstances to issue debentures of more than 66⅔ percent of the total assets of the company, and as a matter of practical control and other guides it is very seldom that we can get above 40 percent.

Senator DOWNEY. Would the payment of dividends from your surplus capital ever act prejudicially to the rights of creditors?

Mr. MYERS. Under our constitution, definitely and emphatically not.

Senator DOWNEY. It could not?

Mr. MYERS. All the assets of our company are pledged to secure, first, payment of the debentures and, secondly, to be devoted to the interests of the common-stockholders. There is a provision, which we now know of as the touch-off clause, which requires that the debentures be liquidated and called, should the assets ever fall below 125 percent of the outstanding debentures. There are other limitations, as a matter of practice; I need not bore you with them; but it would mean that it would be long before the touch-off clause would be invoked, that assets would be liquidated and debentures protected.

In my judgment, it is not possible or legal for the payment of dividends from capital and paid-in surplus ever to act prejudicially to the payment of the debentures.

Senator HUGHES. Am I wrong in stating that when you pay off your stockholders, in the way of redemption, you reduce the security of the creditors?

Mr. MYERS. Of the debenture holders?

Senator HUGHES. Yes.

Mr. MYERS. Naturally. I wish to point out to you, however, that the debentures themselves, in our company, are redeemable. The holder has the same right. Naturally, if a stockholder redeems his securities, the total assets are reduced by that much, and consequently the coverage is that much decreased. However, that is protected against by the operations of the touch-off clause and the other restrictions. You cannot get to a point below which the debenture holders will be harmed. It cannot be done.

Senator HUGHES. In other words, there will always remain enough to redeem and pay off the debentures?

Mr. MYERS. Any time when the assets get below 125 percent, the trustees are called upon to liquidate and to pay off debentures.

Senator HUGHES. Is that provided for in your charter?

Mr. MYERS. That is in the trust agreement under which the debentures are issued. It cannot be changed.

Senator HUGHES. Yes.

Mr. MYERS. That is all I have to say at this time, Senators.

Senator HUGHES (presiding). Very well; we are glad to have heard you.

Mr. MYERS. Mr. Chairman, I should like to present my associate, Mr. Lord, who is president of Affiliated Fund and is also president of Lord, Abbett & Co.

Senator HUGHES (presiding). We are glad to hear you, Mr. Lord.

STATEMENT OF ANDREW J. LORD, PRESIDENT, LORD, ABBETT & CO., INC.; PRESIDENT, AFFILIATED FUND, INC., NEW YORK CITY

Mr. LORD. Mr. Chairman and Senators, my name is Andrew J. Lord. For the past 21 years I have been continuously engaged in the investment business. For the past 10 years I have been president of Lord, Abbett & Co., Inc., which is identified with several investment companies, the largest of which is Affiliated Fund, Inc., of which I am also president. Affiliated Fund, Inc., has assets of approximately $24,000,000, and is the largest open-end company in this country which employs senior capital.

I am appearing in opposition to the investment-trust bill.

Senator HUGHES. Will you explain that now? I do not claim to know all about investment companies or very much about them.

What do you mean by senior capital?

Mr. LORD. Senior capital is the capital senior in rank and priority to common stock. In our case it represents the one class of debentures. Our capitalization is made up of the senior capital of debentures, followed by the common shares of the company.

Senator HUGHES. I want that statement for the record, of course.

Mr. LORD. Yes, sir. Other representatives of the investment trust industry have already stated their views and, I believe, have set forth completely why the industry as a whole is so definitely opposed to this bill as drawn, in spite of the fact that many of us would favor constructive, realistic, and uniform regulation.

My purpose in requesting Senator Wagner's permission to appear is more specific: To set forth our basic objections to section 18 of the bill, which—as you gentlemen will recall—limits capital structures in the future to simply one class of stock and, therefore, prohibits the future issuance of senior securities.

I am not here to discuss complex forms of capitalization such as Mr. Schenker doubtless had in mind when in his testimony he referred to "class A common, class B common, class A preferred, class B preferred, debentures of 1954, and so on."

Senator HUGHES. Well, we have all those in the companies. That seems to be a fashion that has grown up.

Mr. LORD. As I say, I am not here in support of that form of capitalization.

However, I cannot agree with the theory that senior securities should be prohibited, per se. We believe that the investor should have the opportunity to decide for himself after the full disclosure, now required under the Securities Act of 1933, whether or not he wishes to purchase shares in a trust with senior capital carefully limited by the restrictions of a trust indenture.

There is no fundamental difference between this form of capitalization and that generally followed by American business today. Many of our most important corporations employ senior capital for the benefit of the equity holder. To name just a few, the Anaconda Copper Co. has senior securities to the extent of $48,000,000. Bethlehem Steel has $185,000,000 of funded debt, in addition to $116,000,000 of preferred stock. Firestone Tire & Rubber has $95,000,000 of senior securities; National Dairy Products, $67,000,000; Standard Oil Co. of New Jersey, $294,000,000; and United States Steel—Mr. Schenker, to the contrary notwithstanding—has a total funded debt of

$246,000,000, including $100,000,000 of debentures of the parent company.

To be sure, the bill makes no provision for disturbing the present capital structure of investment companies; but we believe it goes beyond the bounds of good judgment, in completely prohibiting the future issuance of senior securities.

Does the Congress wish to tell the American public that they cannot buy the senior securities of an investing company or the common shares of such a company? No law should be enacted that would flatly prevent the borrowing of money for possible greater gain.

It has properly been required that the buyer of investing company shares be given all the facts. Such being the case, the investor should decide for himself whether he wishes to take the risk of greater loss for greater gain. No one should take it upon himself to say that the shares of a soundly constructed and well-operated investing company with certain prescribed amounts of senior capital may not be purchased by investors, in the face of the fact that the shares of a highly speculative promotion may be registered with the Securities and Exchange Commission and sold with no restriction beyond full disclosure.

One of the problems facing the country today is the lack of "venture capital." Through the issuance of senior securities in an investment trust, capital seeking the safety and stability of conservative bonds or debentures finds its way into the purchase of common stocks in the trust's portfolio. This transformation of "safety capital" into "venture capital" is a factor of economic importance generally overlooked in a discussion of investment trust capitalization.

Time does not permit a detailed discussion of the criticisms of the Securities and Exchange Commission with respect to the dangers and abuses of senior securities in the various companies studied. In a recent section of the report of the investment trust study, being chapter 5, dealing with "problems in connection with the capital structure," 369 pages are devoted to "multiple security" companies. Of these, only 4 pages cover "bonds or debentures in open-end companies." Nearly all of the criticisms made, we believe, have been met in the capital structure of Affiliated Fund, Inc.; and those that are not covered by already existing provisions could readily be covered in the kind of a bill which we envision.

There is one thing, and one thing only, that can prevent these problems from being solved to the satisfaction of all concerned: the unwillingness of the Securities and Exchange Commission to work with representatives of open-end companies with this objective. Mr. Smith has stated in his testimony that such a provision could not be included without "complicated legal rigmarole." Our attorneys advise me that such is not the case at all. Mr. Schenker states, and here I quote:

> Now if I may be a little slangy about it, we don't think it is worth the fuss to draw an elaborate provision which probably would be page after page to provide for the situation where a company may want at some subsequent date to issue a little preferred stock.

Our contention is, and I should like to make it as forceful as possible, that it would be relatively easy to draw a provision permitting the issuance of one class of senior securities within certain prescribed limitations.

What should these limitations be? In the discussions that have preceded, one of the members of this committee has stated that he could see no particular objection to the issuance of senior securities to the extent of, say, one-third of total assets. He indicated that he did not favor a complicated system of capitalization, but remarked that some people desired to take greater risk in their investments than others. With that principle we entirely agree.

Based upon our experience, we believe that the limitation of the issuance of senior securities should be somewhat higher than one-third—say, 40 percent to 50 percent—which is still well below the amount an individual can borrow from a bank or stock-exchange firm under present Federal Reserve regulations.

I think there may be some confusion with respect to the borrowing ability of the individual, under the present Federal Reserve regulations. The individual is permitted to borrow 60 percent, not 40 percent. He is required to put up 40 percent margin and, therefore, can borrow 60 percent. In other words, he can buy $10,000 worth of securities with $4,000 worth of capital of his own.

Summarizing our position, we believe that, first, the issuance of senior securities, limited to one class, should continue to be permitted; second, in the creation of a well-protected senior security, we are providing an attractive medium of investment for the conservative investor. Many of the most conservative and sophisticated investors in this country own the senior securities of my company.

Third, so far as the common-share holder is concerned, he should not be prevented by law from the purchase of a more volatile security, particularly when full disclosure is already required in the Securities Act; fourth, a provision covering such a capital set-up is a relatively simple matter to draw and to embody in a bill of this nature; fifth, the prohibition of this type of security runs counter to the history of our economic growth, and is undemocratic in concept.

Before concluding my statement, I should like to impose upon the time of the committee long enough to illustrate the practical effect upon the business of Lord, Abbett & Co., if the bill as drawn should be enacted into law. This may serve to illustrate the reason for the industry's determined opposition to the bill, despite the fact that I believe the Securities and Exchange Commission is entirely sincere in its opinion that the bill as drawn is not only reasonable but moderate in its treatment.

The principal business of Lord, Abbett & Co. is the distribution of investment trust securities, mainly the debentures and common shares of affiliated fund. The bill as drawn prohibits us from the future sale of the debentures.

To all practical purposes, it also prohibits the further sale of common shares of the company; because section 19, paragraph (*b*), provides that no dividends on the common shares of a company with senior capital shall be paid unless the senior securities of such company have an asset coverage of 300 percent. We do not have such coverage; at the present time it is approximately 240 percent and, therefore, we cannot pay dividends; and investors, naturally enough, will not buy investment trust shares upon which no dividend can be paid.

Well, we are therefore effectively prevented from developing Affiliated Fund beyond its present size. Our alternative, then, if we

wish to stay in business, is to start a new company; but immediately we run afoul of paragraph (*b*) of section 11, which prohibits us from acting as investment advisor or principal underwriter of a new company if we already are serving in that capacity for another company, unless the Securities and Exchange Commission in its sole discretion should see fit, under paragraph (*d*) of section 11, to exempt us from the provisions of subsection (*b*).

The theory, gentlemen, of the Securities and Exchange Commission is apparently that, already having this company, we should be restricted from building it larger or from creating a new company unless we can secure the Commission's specific approval.

I submit that this is contrary to the basic philosophy of progress in this country. It is the kind of reasoning that tends to stifle enterprise and to smother the initiative and productivity of our people.

Thank you for your attention.

Senator HERRING. I am just wondering—and I am not suggesting it—whether you could take up your senior securities and issue common in their place, and continue on. Couldn't you?

Mr. LORD. Yes, Senator Herring; I suppose we could call the debentures, and thus have in Affiliated Fund a regular mutual company; because Affiliated Fund is a regular mutual company with the exception that it has the capitalization difference in the issuance of the debentures.

Nevertheless, Senator, that is our business: We believe in Affiliated Fund and its present capitalization.

As I said here, we do not believe that a law should be enacted to prevent people from buying that kind of debentures.

Senator HERRING. I am not saying that I favor it, either; but I am just wondering if that could not be done.

Mr. LORD. Yes, it could be done.

Senator HERRING. So you would not have to go out of business, if the bill passed?

Mr. LORD. Yes, sir.

If I may say so, there is another angle to that matter. First of all, we have in this business, as you may well imagine from listening to the testimony that has been presented here in the past week, some real competition. The State Street Co. and the Massachusetts Investment Trust and all the rest of them are good mutual companies, all of which have been in existence longer than we have. Some of their records are better than ours; and I should think that as a practical matter it would be difficult for us to continue to sell Affiliated Fund in straight competition as a mutual fund. That is a practical business consideration.

Senator HERRING. Yes, sir.

Mr. LORD. Futhermore, as Mr. Myers indicated, there is the possibility and probability that many investors having bought the shares of a leverage company, so-called, have the advantage of the senior securities and the disadvantage that now that the leverage is removed, they are no longer interested in the company and, therefore, under the self-liquidating provisions of the company, would liquidate their shares.

Senator HUGHES (presiding). Thank you, Mr. Lord.

Mr. LORD. Thank you, sir.

Senator HUGHES (presiding). Mr. Dewey, please.

STATEMENT OF BRADLEY DEWEY, PRESIDENT, DEWEY AND ALMY CHEMICAL CO., CAMBRIDGE, MASS.

Mr. DEWEY. Mr. Chairman and Senators, my name is Bradley Dewey. I am president of Dewey and Almy Chemical Co., at Cambridge, Mass., with factories in Oakland, Calif., and Chicago, Ill. I am here as a private citizen, to express my hope that there will be a modification of section 10 (e) (1), having to do with interlocking directors, and to give you my own personal slants on the possible detrimental effect of the size restriction that is one of the other sections, as it may apply to the financing of growing industries.

First, let me speak a few words regarding the effect of interlocking directorates. My own company is a very small one, based on applied research. We run a research laboratory employing some 50 men. It is hard enough to manage all of the diverse angles of the technical end, the engineering, and the selling, without trying to learn also to be a financier.

Because of that, we attribute a great deal of our success—and I think I can say we have been successful, and our securities are now selling for some four times the dollars invested—and believe it is due to the help and advice of two men. I think you have heard from one of them, and you may hear from the other. Merrill Griswold, of Boston, is one of them; and the other is Kelley Anderson. Both of them are on our executive committee.

When we originally organized our business, we went to Mr. Griswold, as an individual. He was then in a position to advise us, to make personal investment in a highly speculative venture at that time. He has been our most loyal, staunchest, and most friendly director and adviser throughout good times and bad times—and we had plenty of bad times in 1931.

In 1931, when times were not so good, we had to go to a new investment trust then forming from old remnants. They were willing to take senior securities and to back us further—they had confidence in us—providing they were in a position to watch and see what we did—a quite proper provision.

Mr. Anderson came on our board at that time, and I have learned to rely on his judgment, and I find him one of our most valued directors. I think I can truthfully tell you that our company would not be what it is today without the advice, help, and direction of those two men.

In order that you may not think that I am here as their paid minion, let me say that it so happens that they do not control, either individually or through their investment trusts or other affiliates enough voting stock to make one iota of difference to my job. It so happens that, as representatives of investment trusts, their investment trust elected originally, in the case when it was consolidated, to take senior securities and nonvoting securities.

The effect of this particular section, as it is now written, because of the fact that neither one of them holds 5 percent of our voting securities, would be to deprive a growing company of the services of two of its most loyal and valuable directors.

You may say that you cannot make an omelet without scrambling eggs. I hope you won't. I think it is unnecessary to take as severe a position as that; and I think that we should be careful, today, not to write legislation that, in order to police someone from doing an improper act, sacrifices the growing businesses of the country.

So much for that personal plea.

Now let us take up the effect of this same thing and the effect of the size provision, as a young chemical engineer in business sees it: Today, we all admit that no investment trust should, unless it is perhaps organized on an entirely different basis than the present ones, go into new speculative promotions; but there is an intermediate stage in the development of new enterprise, when it has graduated from the highly speculative promotional phase, where it must look to individuals for its capital, and yet is not ready to go out to the members of the public who do not know it and who would demand representations that a conservative manufacturer does not like to make. It has developed earning power, but it has not a seasoned historical background.

Now if you say that the investment trust must limit its size, that means that it can no longer take small positions in such business and yet have those positions of sufficient size to do any real good in a developing picture.

I am not maintaining that they should put a lot of their funds there; but I am saying that if our economy is to grow, they should seriously consider small positions in such businesses.

I think that the average investor wants to have a small position in such businesses, and he does not know how to investigate and obtain adequate protection, himself. He cannot afford to; and if he is not protected by the investigating power of the big blocks of capital, he is likely to get mixed up with a lot of fly-by-night things; and then you do not accomplish what you are looking for. In other words, I—as an investor—want the investigating power of the bigger blocks protecting me.

Now what is going to happen if you deprive those fellows of the right to sit on your board of directors and watch that investment? Either they must take voting securities and have more than 5 percent of their funds there—which is a dangerous provision, for some—or they cannot watch those situations, and they cannot help the direction of them.

They are needed in the direction of them; they are valuable men, in many cases. Most of them want to take things like nonvoting, convertible preferreds or something of that type; and you are placing a lot of restrictions on the available mechanisms of capitalization of small industries, as I see it, when you make this prohibition against allowing those men, because they are officers of an investment trust, to sit on the boards of directors of growing manufacturing businesses. I fear that if you go too far with that, you will drive the individual inventor to the large corporations, with their masses of available capital, their big research and engineering staffs that are all geared up to take over his invention and to go ahead.

I fear that, as a result, if you are fearing the power that goes with accumulations of capital, you may be taking a step that will increase that power, and not decrease it.

It is just a question of whether or not that power may be exercised better in an investment trust with diversified holdings, with many interests, with the power of getting out of the bad investment, or by the large manufacturing—so-called in some political parlance—octopus that will be given the opportunity to take over more and more of the smaller inventors and inventions.

I thank you.

Senator HUGHES (presiding). Thank you, Mr. Dewey.

STATEMENT OF HARVEY H. BUNDY, CHAIRMAN OF THE TRUSTEES BOSTON PERSONAL PROPERTY TRUST, BOSTON, MASS.

Senator HUGHES (presiding). Mr. Bundy, of the Boston Personal Property Trust.

We are glad to hear you, Mr. Bundy.

Mr. BUNDY. Mr. Chairman and Senators, my name is Harvey H. Bundy. I am chairman of the trustees of the Boston Personal Property Trust, a "closed-end" trust, which I believe to be the oldest investment trust in the United States. It has been in business for 47 years. It was organized in 1893.

I am going to be brief; I do not wish to take the time of the committee in going over a lot of ground which has already been covered by other witnesses. However, I wish to discuss briefly the special situation of the Boston Personal Property Trust, to touch very lightly on its history, and to show you how the proposed investment trust legislation would affect my particular company.

The Boston Personal Property Trust is what we call in Massachusetts a "strict" trust. During the years, there have grown up in Massachusetts two kinds of trusts, one known as "strict" trusts and the other having characteristics similar to those of a partnership or a corporation. It may be worth while to explain what I believe to be the origin of the socalled strict trust with transferable shares. I believe that it began in Massachusetts originally in the real-estate field and started in this direction because of the obvious convenience of handling real estate in the case of the death of the owner leaving a number of heirs. It has always been inconvenient to own real estate in undivided shares and therefore it was found to be an advantage for the decedent to provide that the title to the real estate should be held by trustees for the benefit of the heirs. In many cases these heirs would desire to sell their beneficial interests; and to meet this situation the trust form was elaborated, and the shares were made transferable and were represented by certificates. Also there were some limitations in Massachusetts to having corporations hold real estate; and that was one of the other reasons.

From the holding of an individual piece of property through the trust medium, it was a natural development for trusts to hold a number of pieces of property; and from its origin in the handling of estates, it was a simple step for individuals who felt inclined to buy one or more pieces of real estate to join in such purchase by themselves creating a trust with transferable shares, and putting the title and the management in the hands of trustees in whose ability and character they had confidence. Sometimes these real-estate trusts owned a large number of buildings, and, from that, they went on to holding more than one group of property.

For example, they might hold a department store downtown and might also hold another piece of property on the outskirts of the business district. In that way, they would spread their risk; and people did do that in Boston.

A substantial part of the real estate of Boston is held by such real-estate trusts, whether originating through wills or through trusts created by voluntary deed of trust. These Massachusetts trusts were also used extensively by Boston investors in acquiring real estate in western cities.

As soon as the trust shares were made transferable, there came into being the two types of trusts, one in which the investors preferred to retain the control of the management of the property by holding annual elections of trustees or by at least retaining the power to remove a trustee, and the other in which the trustees were not subject to control or removal by the shareholders but selected their own successors. One of those groups we call the strict trust, and the other group had the characteristics of a partnership.

In other words, some people said, "We prefer to have John Jones and Bill Smith run our property and have them be our trustees, and not have control over them."

Others said, "We prefer to continue to have control over our trustees and to elect those who will succeed them."

I want to mention the reason for the continuation of the strict trust. You can easily see how it happened in the case of a big family. Suppose you had one conservative son and two rather wild sons. It is perfectly obvious that the conservative son might want to choose Mr. Tom Smith, whom he knew to be a responsible person, and have him continue to operate the trust, without having the two wild sons—whom he did not trust—put in somebody whom he did not like. The same situation existed in the case of a group of gentlemen who got together. Some of them decided, in keeping this strict trust form, that if they were going to be minority holders of the trust, they much preferred to have Mr. Charles Francis Adams, we shall say, and two or three other men whom they thought to be of that ability and character, to choose the successors, rather than to have some fellow be able to buy 51 percent and then put it in the hands of someone whom that purchaser might choose.

Let me point out further reasons for the continuance of this second type of trust. Let us assume that John Jones, a conservative investor, is confident that Smith and Brown are able managers of property and men of the highest character. It is quite understandable that Jones may prefer to invest in a property to be held by Smith and Brown as trustees and to entrust to Smith and Brown the selection of their successor trustees, whereas Jones may be very reluctant to invest his money in a trust where a majority of the trust shares can be acquired by persons of a speculative or unreliable character who might change the policy of the trust and throw out Smith and Brown and put in as trustees persons of inferior ability and judgment. I am not arguing that there is not a real place for the corporate or partnership form of property management, where a majority of the shareholders choose the directors or determine policy. That is the last thing I would do; in fact, most property is held that way. I am merely arguing that there is also a real place in this world for the type of trust which some people prefer—namely, one in which a minority shareholder chooses

to buy the assurance of management by definite, named individuals and the further assurance that these definite, named individuals, on whose character and ability he relies, will be the persons responsible for selecting their successors in the event of death or resignation.

The Boston Personal Property Trust was organized in 1893 by a group of men who had built up a reputation for character and ability in handling other people's property and who felt that there might well be a desire on the part of Boston investors to put their money into a trust similar in structure to the familiar real-estate trust, but one which did not hold real estate as such, but invested in personal property, namely, a general list of stocks and other securities. Their judgment was vindicated and substantial funds were invested. Among these men were John Quincy Adams and President Lowell, of Harvard. They brought forward this movement for investment, Mr. Chairman, at the time of the panic, as a matter of fact; and money was gradually put in. It was not all put in during 1893; it was put in during the succeeding years, until now it has been built up to a value of about 4½ million dollars.

We are a small trust, as they now go. This trust was started long before these enormous trusts were commenced, and there was never any attempt made to expand it. We have not sold stock for years. We do not buy or own stock. We are a closed type of trust.

Let me point out at this time that the duties of a trustee under our law lay a very serious burden and responsibility upon any person undertaking the office, and there are very specific legal limitations on a trustee's action. For example, he may not personally buy from or sell to his trust. He must act with the utmost good faith toward his beneficiaries. I believe that the trustees of the Boston Personal Property Trust for a period of 47 years have undertaken their duties with care and seriousness, and they have built up a reputation for competently managing the property.

I am leaving with the committee a copy of our last annual report, which on the last page shows the time when money was invested leading up to a total value of about $4,500,000 now held by the trust. This report shows the history of our trust year by year, and states the figures for capital, surplus capital, surplus income, total, rate of dividends, and appraisal figures as of November 30 of each year.

I do not think it is a record of great brilliance; I do not claim we are world-beaters. I do not claim that we know when stocks are going up or down; but if you will examine our record, I think you will find it shows a rather creditable performance. I know—or I think I know—that it has been satisfactory to our shareholders. Our mail is not filled with complaints from our shareholders. When you consider that the Boston Personal Property Trust, which was organized during the panic of 1893, has gone through most serious local New England crises in railroads, textiles, and real estate securities—and the real estate crises were still more severe, and we have to some extent invested in the shares of real-estate trusts; likewise, we have been through the railroad difficulties, where the Boston Personal Property Trust usually had a lot of New Haven securities—and when you realize that we have also experienced several national panics, and that in spite of these troubles the trust has shown a satisfactory income yield to its shareholders and a creditable record with respect to the value of its assets, I think you will feel that this

comparatively small trust is not one of those wicked cases so much emphasized by the S. E. C.

In short, if you look at our record, I think you will see it is creditable. I say no more for it than that.

Senator HUGHES. Do you want to offer that report for the record?

Mr. BUNDY. I will offer the last page of our last annual report for the record. If the Senators would like to have extra copies, I have them here.

(The comparative statement of capital, surplus and dividends, of the Boston Personal Property Trust, above referred to, is as follows:)

Comparative statement of capital, surplus, and dividends of Boston Personal Property Trust

Date	Capital (par, $100)	Surplus capital (liquidated)	Surplus income	Total	Dividends (rate)	Appraisal figures Nov. 30 of each year
					Percent	
Dec. 31, 1893	$104,000	$116.65	[a] $111.00	$104,005.65	4	
Dec. 31, 1894	162,000	1,354.03	193.07	163,547.10	4½	
Dec. 31, 1895	241,000	13,181.06	1,221.57	255,402.63	4½	
Dec. 31, 1896	315,000	19,162.11	2,889.77	337,051.88	4¾	
Dec. 31, 1897	419,000	36,620.32	3,352.85	458,973.17	4¾	
Dec. 31, 1898	564,000	84,832.26	5,225.15	654,057.41	5	
Dec. 31, 1899	722,000	179,783.99	7,741.21	909,525.20	5¼	
Dec. 31, 1900	747,000	211,257.16	17,893.02	976,150.18	5¼	
Dec. 31, 1901	842,000	316,773.02	26,366.11	1,185,139.13	5½	
Dec. 31, 1902 [b]	1,326,000	65,666.75	34,598.49	1,426,265.24	54½	$113.10
Dec. 31, 1903	1,333,000	94,419.41	38,199.70	1,465,619.11	4½	103.96
Dec. 31, 1904	1,376,000	129,302.89	42,160.59	1,547,463.48	4½	116.38
Dec. 31, 1905	1,482,000	196,627.44	54,238.67	1,732,866.11	4¾	123.50
Dec. 31, 1906	1,569,000	267,469.34	60,832.36	1,897,301.70	5	124.47
Dec. 31, 1907	1,611,000	273,769.45	64,154.15	1,948,923.60	5½	101.00
Dec. 31, 1908	1,921,000	291,957.82	64,797.90	2,277,755.72	5½	117.20
Dec. 31, 1909	2,059,000	421,788.53	65,034.50	2,545,823.03	5½	128.10
Dec. 31, 1910	2,086,000	488,641.44	48,595.63	2,623,237.07	5⅛	124.92
Dec. 31, 1911	2,094,100	478,106.58	51,680.84	2,623,887.42	5	124.70
Dec. 31, 1912	2,100,200	481,643.25	59,079.04	2,640,922.29	5	126.54
Dec. 31, 1913	2,102,100	479,368.77	76,672.49	2,658,141.26	5	114.49
Dec. 31, 1914	2,102,100	384,359.89	79,005.22	2,565,465.11	5	108.78
Dec. 31, 1915	2,103,500	370,870.13	83,792.03	2,558,162.16	5	114.75
Dec. 31, 1916	2,103,600	302,058.25	106,616.71	2,512,274.96	5	120.33
Dec. 31, 1917	2,103,600	331,811.37	126,914.67	2,562,326.04	5	102.95
Dec. 31, 1918	2,103,600	306,605.14	154,893.67	2,565,098.81	5	108.82
Dec. 31, 1919	2,103,600	318,923.14	178,750.01	2,601,273.15	5¼	112.18
Dec. 31, 1920	2,103,600	332,365.37	202,997.72	2,638,963.09	5⅝	107.79
Dec. 31, 1921	2,103,600	328,620.74	221,158.61	2,653,379.35	6	115.00
Dec. 31, 1922	2,103,600	290,216.24	236,985.52	2,630,806.76	7	132.62
Dec. 31, 1923	2,103,600	285,518.45	253,015.28	2,642,133.73	7	135.05
Dec. 31, 1924	2,103,600	293,492.55	275,160.63	2,672,253.18	7	153.67
Dec. 31, 1925	2,103,600	331,014.68	296,349.11	2,730,963.79	7	177.26
Dec. 31, 1926	2,103,600	274,398.55	314,499.17	2,692,497.72	7	192.14
Dec. 31, 1927	2,108,600	341,408.01	337,411.27	2,787,419.28	8	238.74
Dec. 31, 1928	2,108,600	438,388.32	349,210.08	2,896,198.40	9	286.63

Date	Shares without par value	Capital and surplus	Dividend rate on shares without par value	Appraisal figures Nov. 30 of each year
Dec. 31, 1929	260,860	$4,991,836.21	$0.90	$29.37
Dec. 31, 1930	260,860	5,010,708.73	1.00	24.81
Dec. 31, 1931	260,860	5,031,819.61	1.00	15.21
Dec. 31, 1932	260,860	4,887,300.09	.85	11.13
Dec. 31, 1933	260,860	4,486,488.71	.64	12.58
Dec. 31, 1934	260,860	4,221,928.27	.64	13.52
Dec. 31, 1935	260,860	4,213,670.66	.64	17.12
Dec. 31, 1936	260,860	4,193,909.43	[1] .88	20.02
Dec. 31, 1937	260,860	4,219,825.63	[2] .83	[3] 14.22
Dec. 31, 1938	260,860	4,242,022.70	.64	[3] 16.36
Dec. 31, 1939	260,860	4,251,276.92	[4] .68	[3] 17.08

[a] Deficit.
[b] 50 percent in stock.
[1] Regular, $0.64; extra, $0.24.
[2] Regular, $0.64; extra, $0.19.
[3] Dec. 31.
[4] Regular, $0.64; extra, $0.04.

Mr. Bundy. With your permission, Mr. Chairman, I am going to talk about one matter that is indicated on that page of the statement, which is more or less of a résumé of our history, and I am going to mention one other characteristic. First, we have the characteristic of our trust indenture, which does not require stockholders' meetings or votes. In other words, our group of trustees is self-perpetuating, as a body; and when one trustee resigns, the other trustees elect his successor.

Another provision of our trust instrument which I wish to mention reads as follows:

Each trustee shall be responsible only for his own wilful and corrupt breach of trust, and not for any honest error of judgment, and not one for another. No trustee shall be required to give a bond.

This clause I mention because it may sound to you as if it were a very wicked clause, because it might exempt a trustee from liability for negligence; and I want to explain to you the benefits of that clause to the investor, and to explain just why that clause is in not only this trust but, I would say, in a majority of the Massachusetts probate trusts and a substantial number of other Massachusetts trusts.

When citizens of responsibility become trustees not only for their own families but for the public in general, and where the holder of beneficial interest can sell to any person, it has become evident to them that they are taking on very serious risks of being subject to suits by shareholders, in respect to losses suffered by the trust.

Those of us in Boston operate under a very liberal law with regard to trustees, and it is our practice and the practice of trustees in Massachusetts to invest a substantial part of a large trust fund in common stocks. The rule of the Massachusetts trustee is that he must invest in securities in which a reasonably prudent businessman would invest; and that is all. When you get equity investments, I defy anybody to say whether they are going up or down; and as a practicing lawyer I have had some experience in the courts, and I do know that after a stock has gone down, it is very easy to make a plausible case against a trustee, to say that he ought to have known the stock was going down. You see these wonderful lines that start way up and go way down; and then you say, in the courtroom, "Ah, but at that point you ought to have known that it was going down, Mr. Trustee."

That is a dangerous form of lawsuit—not that it cannot be defended; they are successfully defended.

It is the practice of trustees in Massachusetts to invest a substantial part of a large trust fund in common stocks. We believe that experience has shown, first, that a large trust should have a number of equity investments, having a substantial element of risk, and that no human being can tell whether such an investment is going up or going down in value; second, that after an investment has gone down, in the light of hindsight it is the simplest thing in the world to allege and make a plausible argument against a trustee and to claim that he should have anticipated what actually happened, and that he was negligent in permitting it to happen. Of course, decline in value has not been limited to equity securities. Really the same difficulties are met by trustees in States where they can invest only in securities legal for savings banks—guaranteed mortgage bonds, and other

things—and you will see that it is not only in the case of equity securities that you cannot tell whether they are going up or down; for, Mr. Chairman, many so-called "legal" securities have suffered enormous declines in value.

Many trustees of responsibility and character, especially those who have their own individual property subject to the hazards of litigation, are quite unwilling to be trustees if they are to be subject to suits, however groundless, by any beneficiary on alleged grounds of negligence. Especially when a trust with investments in common stocks is contemplated, a large number of Boston trustees take the position that the beneficiary, if he be an unknown member of the public, must make up his mind whether he is willing to rely on the character and proven ability of the trustees and whether he will forego the right to claim damage through negligence. If he does not care to have his property managed by trustees upon these conditions, then these particular trustees—and I include among them many of the ablest in Boston—say to the investor that he is perfectly at liberty to choose other trustees acting under different trust provisions or for some other investments.

We are not a high-powered trust trying to sell our shares to anybody.

If such protection must be omitted, then in my opinion the result in our section of the country will be inferior trustees or a very timid investment policy; that is what I think will happen. It is perfectly simple and easy for investors to buy Government bonds or Liberty bonds, and nobody will sue them; but if we are perfectly willing to take chances—as you must, in an equity security—then I think the present form is proper.

I repeat that no trustees, at least of the old school, would ever have made the reputation enjoyed by many, at least in Boston, had they been anything but the most careful of men; but the difference between being actually prudent and careful, and being adjudged prudent and careful by a tribunal after expensive litigation, is very great as a practical matter. That is the problem with which they are faced.

Turning from history for a moment to the provisions of the proposed legislation, let me point out what the bill as drafted would do to the Boston Personal Property Trust.

In the first place, through the expense of counsel fees, stockholders' meetings, registration, additional accounting service and reports, surety company bonds, and so forth, I estimate that the beneficiaries would be subject to an additional expense equal to at least a 50 percent increase in the normal Federal tax on their income. The Boston Personal Property Trust operates, I believe, at a lower annual cost to its beneficiaries per dollar of income than any other trust in the United States. I may be wrong; I am not sure that is so; but, at least, the cost is one of the lowest. After talking that over with Mr. Kelley Anderson, I believe there is a fraction of a hundredth of a percent that may vary; and if his cost is lower than ours, I take off my hat to him.

Mr. Griswold. And our costs are lower.

Mr. Bundy. Are your costs lower than ours, too? Well, I take off my hat to you, too. The trustees' fees are limited to 5 percent of the income. The trustees do not receive as much as 5 percent, for 40

percent of this 5 percent is paid for the services of the State Street Trust Co., which is custodian and agent in handling the general details of the operations of the trust. I note that a number of witnesses from the investment company industry have testified that they favor some regulation. Perhaps I am more than ordinarily blind to the necessity of regulation. I may be blind. In the case of the large trusts, regulation may not mean a large expense per share; in their case I do not think that regulation necessarily will cost them a great deal per share. However, in the case of the Boston Personal Property Trust, we are a small trust, and I figure that in our case Federal regulation in any such form as that now proposed will mean a very heavy burden on each of our shareholders.

Second, the provision of the proposed bill which prohibits a trust from having in its portfolio any securities of a company in which one of its trustees is a director, unless the trust holds at least 5 percent of the stock of that company, would require us to eliminate all but one of our trustees, or to change entirely our portfolio of investments. The Boston Personal Property Trust has always turned for its trustees to men of experience and standing in the community. Such men are generally directors of companies whose shares would be natural investments for the trust. You have already heard the testimony of Mr. Charles Francis Adams, our senior trustee. We hold the securities of a number of companies of which Mr. Adams is a director. We hold shares in other companies of which one or the other trustee is a director. Never in my experience of 11 years as trustee have I seen an occasion where there appeared to be the slightest conflict of interest in any matter involving the Boston Personal Property Trust and any company or the investment in any company of which one of our trustees happened to be a director—except, perhaps, one case; and in that instance we just did not happen to buy those securities for our portfolio; and in those 11 years I have not seen a single occasion where I could see or imagine or suspect a condition where our trustees were affected in their judgment by the fact that they were directors in the companies whose securities were held in our portfolio.

Third, the proposed investment trust bill would require a complete revision of our trust instrument, and would force every minority shareholder to be in the hands of the vote of a majority of the shares as to who should be the trustees, no matter whether he personally preferred and invested his money upon the agreement that the present trustees would select their own successors. As to the wisdom of such a change, I have already commented.

Fourth, the trust would also have to be revised to eliminate all provisions protecting the trustees against litigation of the kind I have outlined; and, more than this, the bill would require that no complaint of the usual nature against trustees, alleging breach of duty to shareholders, could be settled without actual suit being brought and, after suit, without the consent of the S. E. C. A groundless $50 complaint by a totally unreasonable shareholder might involve the trust and the trustees in hundreds, or even thousands, of dollars of expense, including trips to Washington, and all the incidental difficulties and machinery of dealing with the governmental body—the S. E. C.—which in my judgment is already somewhat overburdened with other duties.

I have not tried to go in tothe vast number of provisions of this very long bill; but I am convinced that if the bill is passed, there would be very serious question whether the Boston Personal Property Trust, which for 47 years has served its shareholders well, would not be liquidated. I do not know whether it is of the slightest importance to the country at large whether we are liquidated or not; and it is not of much importance to the trustees. I just do not know whether our trustees would be willing to do that; I doubt whether our trustees would be willing to continue with a restricted portfolio and different personal obligations, and I doubt whether the beneficiaries would be prepared to continue with the additional expense involved.

If it is important for national reasons to control large investment trusts, because of their size and power, or if it is important to provide a medium for the investment of money in investment companies closely regulated by the Federal Government, I suggest for the committee's consideration the possibility of having two groups of investment companies in the United States—regulated companies and unregulated companies—and definitely announcing to the public that an investor who puts his money in an unregulated company does so with knowledge that he is not protected by the S. E. C. or by any Governmental regulation and that he takes his chance with only the protection afforded by the common law and the special provisions of the trust instrument, if he is willing to trust the management of any company which is not regulated.

I suggest that it also be left to the decision of the shareholders of companies as small as we are whether they prefer to have their company regulated and supervised or whether they prefer to go on as they now are, with the full understanding that regulation means expense and that regulation means the kind of protection which the S. E. C. desires to give to the investors.

With such an alternative I should be quite willing that our shareholders should make their own decision; and I suggest that it is going a long distance—and I submit a long distance down the wrong road—to so legislate that if, after full disclosure, an investor in Massachusetts prefers to rely on the character and ability of trustees operating under the old, historical form of Massachusetts trust, rather than to invest in some new streamlined vehicle regulated by the S. E. C., he should not have the liberty to choose the older form.

Senator HUGHES. May I ask you a question: How many do you suppose would choose one and not the other?

Mr. BUNDY. I do not know, in general; but I think I have a shrewd guess as to what our shareholders would do.

Senator HUGHES. The fact that a company was regulated probably—to the average investor—would make him feel that he was safeguarded to that extent—and probably to the detriment of one that was not regulated?

Mr. BUNDY. That is perfectly all right with me, Mr. Chairman. If they prefer it that way, that is all right with me.

Senator HUGHES. You are speaking for your own company?

Mr. BUNDY. I am speaking for my own company, and not in general.

I suspect that there would be media of investment, of our character, in which people would prefer to invest because of the character involved and because of the continuity of management.

If you have a large open-end trust, operating all over the United States, with salesmen in every district, I think you probably would find that they would come under that regulation.

Thank you.

Senator HUGHES (presiding). Thank you.

Mr. Orr.

STATEMENT OF JAMES H. ORR, PRESIDENT, RAILWAY AND LIGHT SECURITIES CO., BOSTON, MASS.

Senator HUGHES. Mr. Orr, will you please proceed?

Mr. ORR. Thank you, sir.

Mr. Chairman and Senators, my name is James H. Orr. I am president of the Railway & Light Securities Co.

You have just heard from Mr. Bundy, who is the representative of the oldest investment trust in the country. I think I can say that the Railway & Light Securities Co. is the oldest investment trust company with senior securities outstanding.

I wish to confine my remarks in reference to the proposed Investment Company Act to three phases of its effect on the Railway & Light Securities Co. and its stockholders and on other comparatively small investment companies in a similar position. The points which I should like to discuss briefly are the following: first, restrictions pertaining to senior securities, both debt and preferred stock; second, increased expenses resulting from operations under the numerous regulations specifically set forth or contemplated under the broad delegations of regulatory authority; and, third, the unwarranted management prohibitions resulting from the provisions relating to conflicts of interest.

In so limiting my comments, however, I do not endorse the balance of the act which I think is, as a whole, cumbersome, complicated, and largely unnecessary.

Before discussing the three points which I shall concentrate on, I should like you to have in mind the general set-up and history of Railway & Light Securities Co.

Railway & Light Securities Co. was organized in 1904 with a capital structure consisting of bonds, preferred stock, and common stock. This form of capitalization has continued to date. At present, there are outstanding $4,000,000 in face amount of 4½-percent collateral trust bonds, $2,113,600 par value of 6-percent preferred stock, and $3,327,000 of common stock, the latter figure being computed at asset value. Senior securities, therefore, represent two-thirds of its total capitalization. Interest charges and preferred dividends have been paid without delay since organization, a period of 35 years; and, in addition, a dividend has been paid on the common stock in 27 of the last 30 years. Until 1928, the purpose of the company as set forth in the charter was the holding, for income and for sale, of securities of railways and other public utilities; but in 1928, with the express approval of the stockholders, the company was reincorporated under the laws of the State of Delaware, and the purpose was broadened so that securities of all classes of corporations could be purchased. Six of the nine directors can be classified as investment bankers or affiliates of investment bankers—not all from the same investment-banking house, however. For the most part, these investment

bankers or their firms have been interested in the company since its inception. Subject to the supervision of the directors, an investment manager or investment adviser, as defined in the proposed act, furnishes services to the company; and approximately one-half of the stock of this investment manager or adviser is owned by the Railway & Light Securities Co.

Now fit this statement of facts into the three phases of the bill on which I want to comment, and which are the points which I think affect us very seriously. By so limiting them, I do not mean to endorse the balance of the bill, which I think is cumbersome, complicated, and largely unnecessary. You have already heard comments regarding these other points, from Mr. Myers, this morning.

As I say, the three points to which I shall confine my comments relate to restrictions pertaining to senior securities, both debt and preferred stock; increased expenses resulting from operations under the numerous regulations specifically set forth or contemplated under the broad delegations of regulatory authority; and, last of all, the unwarranted management prohibitions resulting from the provisions relating to conflicts of interest.

Following those in order, first let me consider the restrictions pertaining to senior securities. Our problem on this is not in the future; it is right now.

We have made up a chart showing what the effect of our operations would be, as governed by these proposed provisions, or showing the effect of this provision on our operations since 1906.

You will recall that the bill provides that you cannot pay dividends unless you have an asset coverage of 300 percent—and, incidentally, let me offer this chart for the record at this point.

(The chart entitled "Railway and Light Securities Company, Per Cent Asset Coverage per Outstanding Bond at Par for Determining Dividend Payments Under Investment Company Act of 1940," appears on the opposite page.)

Mr. Orr. In the middle of the shaded zone on the chart is a heavy line which shows 300 percent. Fluctuating around that is the computed asset coverage, as computed in the method prescribed in section 19 of the bill. If you look at that chart, you will see three zones: a "free zone," where you went over 400 percent—and where the S. E. C. can raise the 400 percent statute limitation, too.

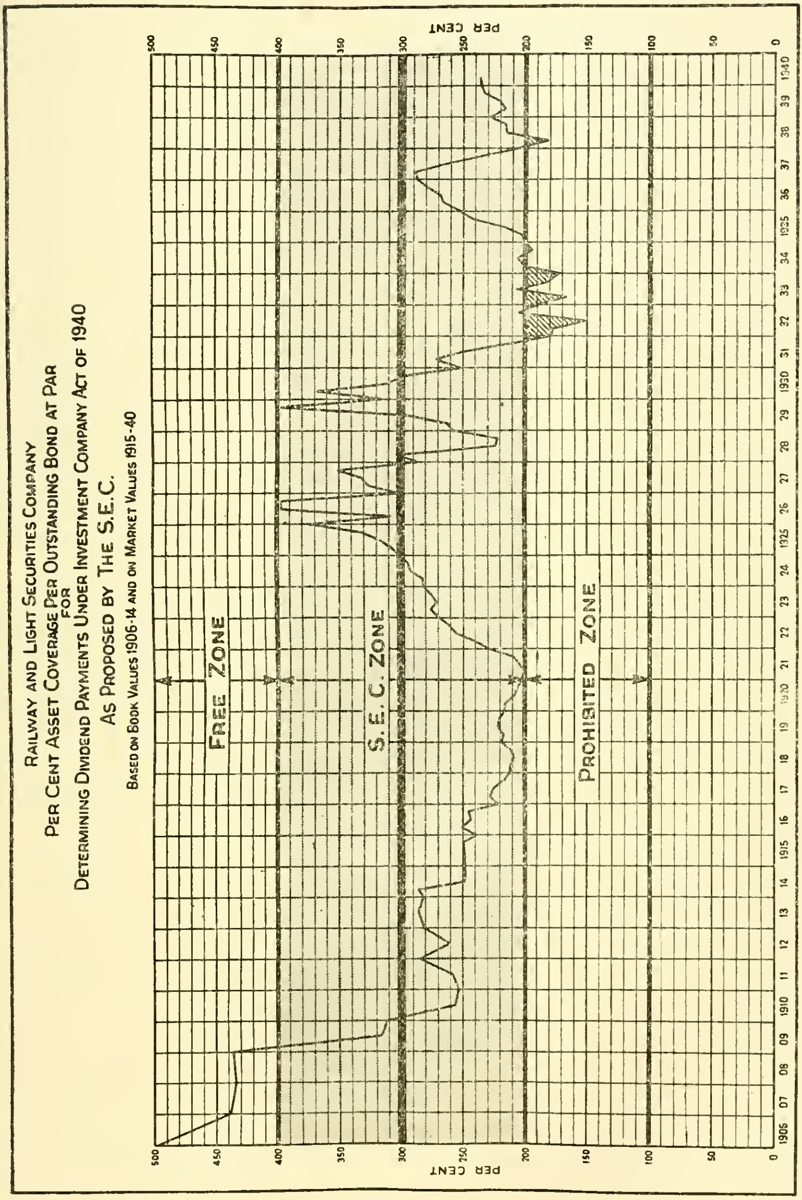
Then you see a shaded zone which is a 200- to 400-percent zone, over which the S. E. C. has jurisdiction.

Below that is a zone where we have gone below 200 percent; and the bill provides that when we are operating in such a zone we can pay no dividends.

At the present time we are operating at about 240 percent, so we are below the 300 percent mark, and we cannot pay dividends on either preferred or common stock unless the Securities and Exchange Commission tell us that we may.

As a matter of fact, in 28 out of the last 34 years, when we paid preferred dividends, we would not have been able to pay them—according to the provisions of this bill—without the approval of the S. E. C.

This, to my mind, does rather grave violence to dividends and to the contractual rights with respect to dividends, as between the various classes of security holders.


Railway and Light Securities Company
Per Cent Asset Coverage Per Outstanding Bond at Par
for
Determining Dividend Payments Under Investment Company Act of 1940
As Proposed by The S.E.C.
Based on Book Values 1906-14 and on Market Values 1915-40
Free Zone
S.E.C. Zone
Prohibited Zone
Per Cent
Per Cent

To recapitulate, we see that section 19, dealing with dividends, makes it unlawful to declare or pay a dividend on any junior securities unless first, the asset coverage of debt equals 300 percent and/or second, the asset coverage for preferred stock equals 200 percent, However, the Commission, by rules and regulations or order, may vary these limits, in the first place, for debt, between 200 and 400 percent asset coverage or, second, for preferred stock, between 150 and 300 percent asset coverage. As contrasted with the foregoing dictated asset coverage, the Railway & Light Securities Co. now has asset coverage of 238 percent for its bonds; so that without obtaining favorable action on the part of the Securities and Exchange Commission, we would be unable to pay either preferred or common dividends. Accordingly, management judgment on dividends and the contractual rights as to dividends between the various classes of security holders represented by the Delaware laws and the company's charter, issued pursuant thereto, are completely set aside.

In order to portray how completely this is done, I have—as I said—prepared a chart showing our bond asset coverage back to 1906; and from this you will observe that in 28 out of the last 34 years, the bond asset coverage has been below the dictated 300 percent. The shaded area shows the range of 200 to 400 percent asset coverage in which the Commission has jurisdiction. At some time during 31 out of the last 34 years, our asset coverage was within this range. In 6 years the debt asset coverage went below the minimum of 200 percent established in the bill; and in such years dividends would have been deferred.

The restrictions I have just referred to apply to both preferred dividends and common dividends; but, in addition, our common dividends would be subject to a required asset coverage for the preferred stock. In the interests of brevity, I am not going into this except to state that we would have been even more restricted with respect to common dividends. Nevertheless, as previously stated, on a nonregulated basis we have paid dividends regularly on the preferred stock and, regularly since 1910—with the exception of 3 years—on the common stock. As far as I know, no bondholder or stockholder has had cause to complain of any injury due to the payment of these dividends.

Mr. Chairman, we have taken a rather lenient view regarding that provision of the bill. The bill provides that we shall figure what the ratio of our assets may be to the total liquidation preferences.

In our company we have two liquidation preferences contemplated by the Delaware laws. One of those liquidation preferences is a voluntary one, and the other one is an involuntary one.

In the case of the involuntary one, that is the one we have worked out here; but if we had used the other one, there would have been a great many more years when we would have been unable to pay dividends; because you see the preferred stock has a call price of 125 for a certain kind of liquidation; and with $2,125,000 of that preferred, there is half a million dollars more coverage which would have to be multiplied by the 200 percent provided in the bill.

Furthermore, a shrinkage of 15 percent in the value of our assets would automatically stop dividends, both preferred and common; no matter how temporary the shrink, the continuity of dividends would thereby be impaired. As the asset value approached these

arbitrary "flash" points, a dividend payment date would present a very interesting problem in market forecasting. The act says that these asset coverages must exist immediately after the payment of the dividend. The declaration of the dividend and the payment thereof cannot possibly take place on the same day; an interval of several days must elapse in order to allow time for the mechanics of payment. A market collapse within this interval could make invalid a dividend properly declared a few days before.

In connection with this dividend question, I should like to point out to you that over the past 25 years, the average rate of return on the invested assets of Railway & Light Securities Co. has exceeded the cost of the senior money, including as part of such cost an allocation of our operating expenses and taxes. This is contrary to figures submitted to you earlier in this hearing indicating that the average rate of return on invested assets would be between 4½ and 5 percent, which would be less than the cost of the senior money irrespective of expenses and taxes.

Now bearing in mind that the proposed act is allegedly designed to be in the interests of investors, what proportion of investors in securities of investment companies are not benefited by such provisions, but on the contrary are injured by having their rights to receive income seriously impaired, and, therefore, the market value of their holdings. Certainly, it would be a new investment concept that it is an advantage to an investor to have additional uncertainties and conditions imposed on his rights to receive income.

The Commission's report shows that at the close of 1936, the common stocks of 102 "management investment companies proper" and "management investment holding companies" which had senior securities outstanding ahead of them, had an equity value of $1,243,000,000. In addition these companies had outstanding $239,000,000 of preferred stock preceded by debt. The total of these holdings of common and preferred stocks aggregated $1,482,000,000 and all of them will be adversely affected by these uncertainties as to future dividends; this figure represents 40 percent of the $3,673,000,000 total assets of all management investment companies that were classified in this report.

Furthermore, these restrictions operate without taking into consideration the character of the assets of the company, which can range from Government bonds to the thinnest of thin equities. In the case of Railway & Light Securities Co., it has been our general practice to hold bonds in the portfolio in an amount approximately equivalent to the face amount of our own debt outstanding. We do not in any way recommend this as a restriction which should be pressed generally on the industry, but it is a very important factor in determining, in the language of the bill, the speculative character of the junior securities of Railway & Light Securities Co. This is a recognized theory in banks and financial institutions and should apply equally well in the case of investment companies. I quote from the Monthly Review of the Federal Reserve Bank of New York for April 1, 1940 [reading]:

> From one viewpoint, perhaps the most significant capital ratio is the percentage of capital funds to the total of all bank assets in which there may be shrinkage in value under adverse conditions. * * * Such protection (afforded bank depositors by bank capital) depends upon several other factors, including the proportion of cash held by banks against their deposits, the proportion of bank funds invested in assets subject to potential shrink in value and the character of such assets.

As a matter of fact, the dividend provisions of the bill might result in forcing liquidation of this company in whole or in part. As previously pointed out, dividends on the preferred stock will be largely contingent on fluctuations in the market value of our assets and the Commission's discretion. This certainly does sufficient violence to the rights of the preferred stock, so that a holder should be offered some alternative. The only alternative which the company could proffer would be liquidation. But before we could do that we apparently have to come back to Washington and take up the matter with the Commission all over again to be sure we are not violating section 23 (b), which prevents retirement of securities in contravention of rules or orders of the Commission. This section 23 (b) again subordinates management control and judgment to the will of the Commission and this time in the important field of refinancing.

The foregoing applies to senior securities now outstanding and does not apply to new issues, because under section 18 of the act no such securities could be issued.

Now consider this section 18. Take first the simple case of a reorganization or consolidation of two companies with senior securities outstanding and, in my opinion, if the act is passed, there will have to be many such consolidations, due to the necessity of greater size in order to bear the burden of increased expenses incident to operation under the act. It is conceivable that in all such reorganizations or consolidations the equities and interests of all security holders, both senior and junior, can be effectively represented in a new issue of only common stock? My experiences and observations have been decidedly to the contrary. Perhaps some new capital may be required to effect the reorganization or consolidation; if the new capital cannot be raised via common stock, the proposed act is an effective bar to the whole program. Instead of helping the small investor, this may well result in freezing him out of any possible chance at a recovery from a period of depression. Even the Public Utility Holding Company Act, which limits the types of financing which a utility holding company may effect, recognizes the peculiar characteristics of mergers, consolidations, reorganizations, and other special situations by removing the ordinary limitations in such cases.

You have been told that banks are permitted to have only one class of capital stock. I would call your attention to the fact that since 1933, national banks have been permitted to issue capital notes and/or preferred stock and many of them have taken advanage of this permission. Was it against the interest of investors in bank stocks to have the Reconstruction Finance Corporation purchase over a billion dollars of preferred stocks of such banks? On a strictly comparable basis, bank stocks were already margined over 6 to 1, and it is now over 8 to 1, because their deposits, which are payable on demand, are just as much a debt as a bond, payable at a future maturity date.

My difficulties with the senior capital restrictions go further, however, than just the effect on existing capital structures and on reorganizations and consolidations. The bill proposes not only to eliminate abuses, but also to dictate economic behavior by investment companies and by the public which buys securities of such companies. You will recall that comment has been made earlier in the testimony before your committee of the merits of investment companies for the diversification of risk for the small investor. But suppose the small investor

wants that diversity as a backing for bonds and preferred stocks for the sake of income security, will you say to him, as this act does, "No; you cannot have the diversity without taking a risk of fluctuations in your capital and the income therefrom?" As fiduciary trusteee, or agent for such an individual, would you assume the risk for the sake of diversity? I am sure I would not; and, accordingly, in my opinion, this proposed act removes from the economic and financial systems an investment medium, which is well suited to the needs of the very class of people the act is designed to protect.

As an example of what I mean, 75 percent of our bondholders are women and fiduciaries; approximately two-thirds of our preferred-stock holders fall in this same classification. The act does not alone dictate the type of security which shall be available for this very conservative investor, but it also dictates the behavior of the individual who wants to strive for a rapid increase in his capital to the point of wanting leverage. This individual is to be forced to create his own leverage by buying on margin with a broker or through a collateral bank loan the stock of an investment company having only one class of securities outstanding. Certainly, in the ordinary case, the speculative characteristics of this operation are much greater and so is the hazard to the individual. Yet the Federal Reserve Board in establishing limits on borrowings against securities has not prohibited borrowings on investment company securities, but merely classified them with other types of borrowings, some of which are on securities even more speculative.

There has been inquiry made of witnesses earlier in your hearings as to the extent to which investment companies should be permitted to issue senior securities. In the case of Railway & Light Securities Co. our certificate of incorporation contains a provision that the company shall not issue additional debt and/or preferred stock, if thereby these senior securities will aggregate more than three times the amount of the value of the common stock. This permits debt and preferred substantially in excess of the coverage limits contained in the dividend section 19 of the proposed act; notwithstanding this, we have maintained a high investment rating for both the bonds and the preferred stock and I fail to see how the issuance and service of these securities has been against the public interest or the interest of investors.

In 1935, the investing public paid par for our bonds currently outstanding with a required asset coverage written into the bonds of only 120 percent. At no time since their issue have the bonds to my knowledge sold below 97 and yet at no time has the asset coverage been as high as the dictated 300 percent. Interestingly enough the ratio of our company's senior securities to the common stock equity is practically identical with that required by the Federal Reserve Board for collateral loans, as covered in regulations T and U issued by the Board of Governors of the Federal Reserve System pursuant to the Securities Exchange Act of 1934. It would be my recommendation that the limits on the issue of additional debt be set at approximately the requirements established in the ruling of the Federal Reserve Board previously referred to, but that additional leeway be permitted for preferred stock. The experience of my own company would indicate that an overall restriction of debt and preferred stock of three to one is not disadvantageous to investors.

But irrespective of the limits so placed, broad exception[illegible] result made in the case of reorganizations and/or consolidations [illegible]

With regard to increased expenses resulting from operations under the act, any list or discussion of increased expense items will of necessity be incomplete in the absence of actual working experience under the numerous rules, regulations and/or orders contemplated by the broad delegations of authority to the Securities and Exchange Commission. I can point out the major ones traceable to specific requirements of the proposed act.

1. There is required a notification of registration, followed by a registration statement in such form and containing all the information and documents required of an issuer of securities under the Securities Act of 1933; notwithstanding that a particular investment company may not be an issuer, all of this information must be filed. But it does not stop there, we must also file such additional pertinent information and documents regarding the company or its affiliates as the Securities and Exchange Commission may wish, including periodical and special reports in unknown form and at unknown times, minutes of directors, stockholders, and other meetings and the answer to such specific questions as may be required. Any financial statements so required must be audited. Detailed information as required must also be obtained from investment advisers and underwriters. Under the proposed act, the filing of further material to keep this information reasonably current can and doubtless will be made a recurring obligation and therefore a recurring expense. In addition, there will be the burden of constant checking with portfolio companies to avoid possible cross-ownership.

2. Directors compensation will have to be materially increased because (*a*) they must in turn register (*b*) they may have to be bonded, (*c*) they must be paid a flat fee and not a fee for attendance at each meeting, (*d*) they must be prepared to analyze their own individual security transactions for the purpose of reporting transactions in securities bought or sold by the investment company, (*e*) they must be induced to resign from the directorate of any company whose stock is held by the investment company (except in those rare cases where the trust holds over 5 percent of the stock of the portfolio company, (*f*) if the director can be classified as an investment banker or an affiliate of an investment banker, he will lose an opportunity to do business with the investment company on an equal footing with other investment banking houses, (*g*) there is an additional risk due to the outlawing of exculpatory clauses.

3. Management fees may have to be increased because a substantial number of the points above under directors apply also to managers or investment advisers.

4. Under section 17 (*f*), the charter, bylaws, trust indenture, manager underwriting or brokerage contracts and/or any other instrument must be amended from time to time to eliminate any provisions in conflict with the act or future rules and regulations of the Securities and Exchange Commission, when, as and if the latter may be issued. In our case, we would have to propose promptly to our stockholders that they authorize material changes in our charter because in various places it "purports to authorize the violation of any provision of this title."

wants th[illegible]ition, the title of the company or of any security must th[illegible] when the Securities and Exchange Commission determines that it [illegible] not accurately descriptive of the company's business. Many of these changes will require calling a special stockholders' meeting and incurring all of the expenditure of money and time incident to corporate changes. I have grave misgivings about this section 35 (d). Under this section, the Commission can force companies to change their corporate title, or the title of any security, in accordance with the definitions under section 5 and may be even otherwise than contemplated in its definitions. In many cases of companies of long standing, there is a definite goodwill value attached to the name, but this good will can be dissipated merely because the Commission finds that any word or words are misleading. Railway & Light Securities Co. formerly was limited to the purchase of railroad and utility securities, but this is no longer true. Will we be required to change the name of the company and all of our outstanding securities, incurring the expense incident to amending the certificate of incorporation and reengraving all of our bond and stock certificates?

6. The Securities and Exchange Commission can require any corporate changes necessary to effect an equitable redistribution of voting rights and privileges. Entirely aside from what this requirement does to contractual rights existing under the law of the State of incorporation, what procedure must a company go through if the stockholders will not vote the necessary consent to the charter amendment? Legal studies and actions to accomplish changes of this type can be extremely expensive. In this connection, who is guilty of a breach of the law if the stockholders refuse to ratify these dictated corporate changes? Perhaps the penalty is revocation of registration which practically means cessation of business. In other words, the proposed act says to the stockholder or bondholder for that matter, never mind the Delaware law or your contractual rights under it, you vote to change these things or your company stops doing business.

7. Prevents the possibility of lowering fixed charges through refinancing existing debt or preferred with senior securities bearing lower coupons or charges.

Most of these requirements will fall with equal severity on the small company and the large company, that is equal severity in terms of dollars. As a percentage increase, however, in operating expenses the small and moderate size investment company and their stockholders will be severely hit. One of the purposes of the bill is to mitigate and, so far as is feasible, to eliminate the undue concentration of control or management of investment companies or the attainment of too great a size; yet by its very provisions, the act penalizes the small company. Between sections 10, 11, 12, and 15, the method of group operation of investment companies employed successfully by the British companies over a long period of years cannot be followed. This method is well adapted to small companies, from an economy standpoint. For example, there are a total of 14 companies in the so-called Robert Fleming & Co. group in England. The average size of these companies is £13,000,000. If a substantial portion of these numerous and expensive requirements stay in the bill, the provisions

of sections 10, 11, 12, and 15 should be modified to permit group management.

I mentioned above the necessity for making certain amendments to charter and contract provisions. Our collateral trust bonds are convertible into common stock at the election of the bondholder. As a matter of fact, our common-stock holders waived their preemptive rights to such common stock to make the conversion contract with the bondholders. Naturally, the bondholder is not going to be interested in converting to the common stock unless the asset value at the time is greater than the conversion price. But section 23 (*a*) of the act says that we can never issue common stock for less than asset value at the time of the issue. In the absence of retirement of our bonds by call at the redemption price of 105, we would certainly have a contract outstanding calling for the violation of section 23 (*a*) of the act, but here again section 23 (*b*) applies governing the call of securities and, furthermore, there is the question of whether it is in the interests of our common stockholders to be forced to retire 4¼ percent debt at 105.

But the conversion rights of our bonds are further affected by section 18 (a) (4), which requires all nonredeemable stock hereafter issued to carry broad preemptive rights. The preemptive rights of our present common stock, into which our bonds are convertible, are carefully limited so as not to interfere with the conversion rights of our bonds or with issues of stock for property. Does section 18 (a) (4) mean that we have to give to the common stock into which our bonds are convertible broader preemptive rights than our present common stock has? This would vary their contract, whether to the benefit or detriment of any class of securities one cannot say. Assume we do give such preemptive rights to that stock, and a part but not all of our bonds are converted, which is the way such conversions take place. Would this mean that further conversions could not be made unless those who have already converted waive the preemptive rights given them by the act? Could those who first convert block all other conversions?

I pointed out to you earlier that ever since its inception, Railway & Light Securities Co. has included among its directors men identified with the investment banking or brokerage business. Accordingly, the provisions of the proposed act which will eliminate these men from the board are contrary to a policy approved by the stockholders over a long period of years. I have checked the boards of directors of the 15 largest savings banks in the United States. Eleven out of the fifteen have on their board one or more men identified with the investment banking business or the brokerage business. The assets of these banks aggregate over $3,766,000,000. A casual check of many educational and charitable funds devoted to the public welfare reveals that they likewise have turned to this financial profession for investment advice and assistance. It indeed seems strange that men capable of assisting in the management of funds of this type and size, should be outlawed from investment companies under any theory.

The main contentions against using these gentlemen as directors have been summarized as conflicts of interest. Conflicts of interest have, of course, long been regulated by common-law principles and rules. These enable transactions affected by such conflicts to be upset if unfair. The banking and brokerage profession or industry itself

suggested some time ago further workable restrictions in adopting their 1934 "Code of Fair Competition for Investment Bankers" approved on March 23, 1934, by President Roosevelt. Article VIII of this code expressly dealt with investment company situations. A copy of this article VIII is submitted with a request that you permit its inclusion in the records of this hearing.

Senator HUGHES (presiding). That will be included.

(The Code of Fair Competition for Investment Bankers referred to and submitted by the witness, is as follows:)

CODE OF FAIR COMPETITION FOR INVESTMENT BANKERS BY INVESTMENT BANKERS CODE COMMITTEE

ARTICLE VIII. RULES PERTAINING PRIMARILY TO INVESTMENT COMPANIES

SECTION 1. If any investment banker has agreed to manage, or give investment advice to the management of an investment company (sometimes known as an "investment trust") all or part of the securities of which are held by the public, or if any partner or officer or employee of any investment banker is an officer or director of any investment company all or part of the securities of which are held by the public.

(*a*) Such investment banker shall not for his own account sell to or purchase from such investment company any securities unless a majority of the members of the board of directors of such investment company are not such partners, officers or employees, and unless the transaction is previously approved after full disclosure by a majority of such members of the board of directors of the investment company.

(*b*) Such investment banker shall use his best efforts to cause the investment company to prepare and distribute to its stockholders quarterly statements and annual financial statements, such annual statements to conform to the standards for such annual statements required by section 1 of article IV hereof.

(*c*) If such investment banker has received any compensation or commission for acting as agent for the investment company, or if such investment company has purchased from or sold to such investment banker any securities, or if the investment company has engaged in any other tarnsaction in which the investment banker has a financial interest, the investment banker shall use his best efforts to see that full disclosure of such transactions is made by the company to the stockholders at an annual or special meeting. Where the investment banker has acted simply as broker for the execution of orders on a securities exchange it shall be sufficient disclosure if the total amount of securities dealt in and the total amount of commissions received shall be stated.

(*d*) Such investment banker shall not enter into any management or advisory service contract with such investment company providing for the payment to the investment banker of any fee or for any other compensation for managing or advising the management of the investment company unless the contract therefor has been submitted to and approved by the stockholders of the investment company.

(*e*) Such investment banker shallu se his best efforts to cause the investmen company not to use the term "trust" as part of the title of such investment company unless the use of the term "trust" is justified as a matter of law.

Mr. ORR. I have suggested the inclusion of the entire article because in addition to the restrictions on so-called self-dealing, they contemplate regulations which would go far toward correcting malpractices of the past in investment companies. You will observe that an independent majority of the directors must approve any transaction with the firm of an investment banker who is on the board. This and the other provisions of article VIII represent simple and workable rules which, I think, could properly be included in the legislation which you are considering.

Summarizing, in regard to the bill as a whole, I agree, in general, with the views which have been expressed here by other representatives of the industry. There is no emergency situation here that

requires hasty action to impose a strait jacket upon this industry. I urge that further careful and detached consideration be given to every proposed provision, if the committee concludes that some legislation is necessary. And I urge particularly that the provisions rigidly restricting dividend payments, regardless of contractual rights, those wholly forbidding senior security issues, and those virtually banning bankers and brokers from directorships, be carefully reexamined in the light of actual needs and results so that, if some restrictions on these matters are decided upon, the restrictions shall be limited to what is necessary, simple, sensible, and workable.

Senator Hughes. Are there any questions?

Senator Herring. No; I have none.

Senator Hughes (presiding). We will next hear from Mr. O. Kelley Anderson, president of Consolidated Investment Trust, Boston.

STATEMENT OF O. KELLEY ANDERSON, PRESIDENT, CONSOLIDATED INVESTMENT TRUST, BOSTON, MASS.

Mr. Anderson. My name is O. Kelley Anderson. I am President of Consolidated Investment Trust. Our address is 111 Devonshire Street, Boston, Mass.

Let me tell you a little of what Consolidated Investment Trust is and what the trustees are seeking to do for the shareholders. It is a voluntary association organized under an indenture of trust in 1933 under the laws of Massachusetts. It has its place of business in Boston and its affairs are managed by a board of nine trustees. It is a closed-end investment company and has one class of shares of beneficial interest which are owned by approximately 4,500 shareholders. The average holding at December 31, 1939, was approximately $3,200 and at that time the assets of the trust were valued at approximately $14,000,000. The trust was formed by the consolidation of four Massachusetts corporations organized from 1921 to 1928.

The trustees have broad powers of investment. At the present time the trust has approximately 70 percent of its assets in securities dealt in on national exchanges. The balance is invested in real estate (approximately 5 percent) and in what may be called "special situations" (approximately 25 percent). This last group consists, for the most part, of investments of considerable size in industrial enterprises of relatively recent organization, many of which our trust or its predecessors assisted in financing.

Since the organization of our trust these investments in special situations have, for the most part, proved quite advantageous. It is the belief of the trustees that it will be in the interest of the shareholders of the trust, as opportunities are available, to make new investments in similar enterprises. We believe that there is a profitable field of investment in small or medium sized enterprises which need funds either as new money or to replace old money in connection with the refinancing of such companies.

A way in which this financing can be done, and if one may judge from the press, a way believed by the Commission to be desirable, is to have some kinds of investment companies which can furnish the money needed to such enterprises. Financing by investment companies is particularly desirable for enterprises which need permanent capital in sums more than $100,000 but less than $1,000,000 because

of the great expense of raising such sums by public offerings registered under the Securities Act of 1933. Consolidated Investment Trust believes this type of financing is desirable and has recently made a further investment in two of the special situations in which it had an interest.

Investments in special situations of the variety which I have described above are obviously different in kind from investments in large and well-established companies such as American Telephone or General Motors or Sears, Roebuck. We would expect to and do follow these special situation companies much more closely than could be possible in the case of most of those large companies. We feel that if we are going to invest a substantial amount of money of the Trust in these smaller companies we should take an active supervisory interest in their management and generally we should have one of the trustees on the boards of directors of these companies.

I would like to discuss with you the effect of the proposed law upon our shareholders. As Consolidated Investment Trust has the simplest form of capital structure, does not sell its shares and does not now have any "manager" or "investment adviser," many of the provisions which might affect other companies do not concern it except as an investor. It seems well to limit this discussion to those provisions which more directly have an adverse effect upon our shareholders. I have divided this subject into four headings, which are quite closely related one to another.

1. The provisions as to the choice and election of directors and trustees.
2. The limitations upon investment policy.
3. The increased expense to our shareholders.
4. The effect of the bill upon financing of small companies and underwriting of other securities by investment companies.

With reference to the provisions as to the choice and election of directors and trustees, it is essential that a management investment company have good management. This bill does nothing to improve the quality of management and actually excludes individuals no matter how desirable from acting as directors or trustees.

Besides myself, there are on our board of trustees two lawyers, an engineer, a manufacturer, an investment banker, two professional trustees, and the financial vice president of Harvard College. All of us are directors of other business organizations of various sorts, including banks, railroads and industrial concerns. This board meets every month. In addition, there is a flexible executive committee of three trustees which meets more frequently and has proved to be an extremely useful instrument in the management of the Trust. We conceive that it is the duty of the directors or trustees of an investment company to use their free and unbiased judgment to act as wisely as they can in the management of the funds in their hands for the benefit of their shareholders.

Section 10 has a number of extremely complicated provisions as to who may be a director or member of an executive committee of an investment company. These provisions form a crazy quilt of rules, prohibitions, and exceptions which we believe to be very badly conceived and which, if enacted, will operate to the detriment of our shareholders and of shareholders in investment companies generally. The

alleged purpose of this section is to prevent certain conflicts of interest which the draftsman deemed iniquitous. The result, however, of these rules will be that either the shareholders will not be able to have their directors free to make what they judge to be the most desirable investments or that the shareholders will be deprived of the benefit of the judgment of men fitted by training, experience, and connections to act as directors.

Perhaps it would be helpful to the committee to discuss some of these rules in detail from our standpoint.

Subsection (*a*) provides that a majority of the board or executive committee cannot be affiliated with any one company other than such registered investment company. This does not present serious difficulties for the board of trustees of our trust so long as the number is nine; but if because of the increased expense due to the effect of other provisions of the bill it were necessary to reduce the board to three it could be very harmful. This provision means that there cannot serve at any one time on our executive committee of three, two trustees who are directors of the same bank or railroad or manufacturing company or hospital or wardens of the same church.

It is true that subsection (*b*) gives a limited exception to this rule for existing members of the board of an investment company who are affiliated with a bank. But this is a most illogical exception to an illogical rule.

Senator HUGHES. Don't you think you are going pretty far when you refer to wardens of the same church being prohibited from serving on the executive committee?

Mr. ANDERSON. Perhaps I am going a little too far there. If persons who are affiliated with one bank are unfit to become a majority of the board of directors or executive committee after the effective date of the act, it is hard to see why persons in the same category are not equally unfit, although they hold office on the effective date. It seems clear that the draftsman did not care to be consistent but rather sought to sacrifice the interests of investors for the benefit of persons now falling into such a category.

Subsection (c) says that no investment banker or broker and no affiliated person of such banker or broker may be a director of an investment company if he is a director, officer, or manager of another investment company not in the same system. The purpose of this is most obscure. There seems to me to be no reason for saying the broker or banker is a less suitable person because he or one of his affiliates is connected with another investment company. In our experience it has been very helpful to have the viewpoint and experience of an investment banker at our trustees' meetings. We have an investment banker on our board and although he is not a director of any other investment company, one of his partners is a director of another investment company in another city, so that one of them would be disqualified.

Subsection (d) relates to persons who may not be the "investment officer" or "manager" of an investment company. Under the definition of "investment officer" as it stands in section 45 (a) (15), when the board of directors votes to buy 100 shares of Telephone at a stated price and instructs one of its members or another officer of the company to attend to having the vote carried out, that member or officer is an "investment officer." I am barred from performing this purely ad-

ministrative function because I am an officer of another investment company.

Subsection (e) is extremely objectionable and most injurious to the interests of the investors.

If you were to choose an individual to be in charge of your property after your death, you would want to select a man with broad business experience and you would consider it extremely desirable to select a man who was a director of companies in which you owned securities. The fact that he was such a director would be an added recommendation because it indicated that he was considered by others to be an experienced and able person.

So it is with investment companies. They believe that it is highly desirable for their shareholders to have among their directors men who are on the boards of large companies. If subsection (e) is enacted, Consolidated Investment Trust (*a*) will have to ask each of its trustees to give up his connections with the companies of which the trust owns less than 5 percent of the voting securities, which these individuals will, naturally, not wish to do, at least without greatly increased compensation from the trust, and this would apply to seven of our nine trustees; or (*b*) it will have to dispose of its holdings in all of those companies and be precluded thereafter from owning securities in any of those companies, thus limiting the power of the trustees to act as wisely as possible for the best interests of the shareholders of the trust, otherwise these trustees must resign. This is so obviously ridiculous that further elaboration seems unnecessary.

In addition to the foregoing general objection, Consolidated Investment Trust has a further objection to this provision as it relates to the special situations which I mentioned before. In general, we would not want to invest the money of our shareholders in a relatively small company unless we could have one of our trustees to serve on the board of directors of that company. Our investment might be in the form of voting common stock, in which case we would not be apt to come within the prohibition of subsection (e) (1). That is, if it exceeded the 5 percent.

Our largest single investment happens to be in nonvoting common stock in a company of which I am a director and a member of the executive committee, and under this provision I could not continue in that capacity. Our investment might, however, take the form of preferred stock or bonds or an extension of credit in the form of an endorsement. In all of these cases our interest would be as great as if we bought voting stock and yet under the bill as it now stands we would be prohibited from having one of our trustees on the board of the portfolio company.

We do not intend to exercise control over the special situations in which we make investments. We do believe that we ought to supervise them. It is obvious that the prohibition of subsection (e) (1) is not related to any concept of control of the portfolio company, for ownership of 5 percent of the voting securities in a small portfolio company might well not amount to anything from the point of view of control of the company. If this provision is allowed to remain, the availability of Consolidated Investment Trust as an instrument in the national economy for the financing of small companies will be greatly limited.

Subsection (e) (2) prohibits an investment banker or broker or an affiliated person of an investment banker or broker from acting as director or officer of an investment company if he is also a director or officer of an issuer of which the investment company owns any security, regardless of the character or amount of the security so owned.

This provision would disqualify the single investment banker on our board even if he should escape the disqualification which I have already mentioned. The criticism made under subsection (c) is equally applicable here. An investment banker or broker is no less suitable as a director of an investment company because of the fact he is a director of a portfolio company.

As indicated above, I believe that that would make him a more suitable person.

Section 16 of the act requires directors or trustees of an investment company to be elected by the holders of the outstanding voting securities at the annual meeting or at a special meeting called for that purpose. Provision is made for the filling of vacancies not exceeding in the aggregate a third of the whole number of the board. Our indenture of trust provides for election of trustees by classes for three-year terms, the term of one class expiring each year. It is improbable that the drafters of this bill intended to prohibit that plan of election, but it apparently has that effect. Similar provisions are to be found in the business corporation laws of many States. Similar provisions may be made in Massachusetts for the election of selectmen by town meetings.

The principal purpose of having the directors elected by classes is to secure continuity of management and to insure, as far as possible, that each director will hold office for a period long enough to accumulate knowledge and experience in dealing with the problems of the company.

A provision for the election of directors by classes is particularly necessary in the case of Consolidated Investment Trust because of the investments in special situations which I have mentioned before. The most advantageous treatment of these investments requires considerable knowledge of the particular problems of the portfolio companies involved. We believe that the interests of our shareholders should be protected by allowing the existing provision of the trust indenture which stipulates that the trustees shall be divided into three classes, one elected by the shareholders each year, to remain in effect.

Regarding limitations upon investment policy, notwithstanding the statements of the Commission to the effect that it does not seek to control the investment policies of management investment companies, it is obvious from section 5 (d) and section 13 (b) that the Commission is asking for the broadest kind of control over investment policies. We agree that an investment company ought not without the consent of the holders of a majority of its voting securities to change the announced or declared investment policy of the company. The Commission, however, has asked to have the unlimited power to determine from time to time what the fundamental policies are and this means that the Commission may at any time make a determination which prevents the directors or trustees from using their discretion for the best interests of the stockholders.

The very unfortunate rules proposed in section 10 with respect to the selection of directors or trustees will operate to limit the invest-

ments which may lawfully be made by investment companies. I have already discussed this section above and so will not repeat here our objections to those rules.

As to the increased expense to our shareholders, one of the things which will affect shareholders in investment companies most is the increased expense of operating under the proposed law and the rules, regulations, and orders which the Commission in so many instances is empowered to make. The increment of expense for small investment companies will be greater per dollar of asset value than for large companies. Ultimately the stockholders will have to bear this expense in the form of reduced earnings. Now, of course, the increased expense is the price the stockholders must pay for the increment of protection which the proposed law may give them. It may be that the Congress will conclude that the increased expense is a reasonable price to impose on stockholders for this protection and it may be that the judgment of Congress will prove to be sound.

It seems well to point out some of the elements of this expense and how it will affect Consolidated Investment Trust.

As I have indicated, Consolidated Investment Trust has a very simple structure. We have already sought to reduce the cost to the stockholders of operating the trust and I believe that we may be justly proud of our results. The ratio of operating expense of the trust to income from dividends, interest, and net rents, that is, excluding capital gains, was 7.8 percent in 1939. From a comparison which we have made with the records of operation of other management investment companies, we believe that this is the lowest operating ratio of all such companies and we know of only two other companies which come even close to this figure. We are very anxious to preserve for our shareholders the low cost of operation which has obtained heretofore.

The bill will impose different kinds of expenses. In the first place there are the elements of what may be called initial or organization expense incident to registration under the proposed law and to amendment of the trust indenture as required by section 17 (f) to conform to the law as enacted and the rules, regulations, and all orders promulgated by the Commission during the first year and incident to setting up the system of accounts, cost-accounting procedure, correspondence, memoranda, and other records which the Commission is empowered to prescribe. These elements of initial expense will be considerable. Then there are the elements of expense of amendments every time the Commission adopts a rule, regulation, or order making the existing provisions illegal and of revising the system of accounts and records every time the Commission changes its rules, regulations, or orders. These elements of expense are, of course, problematical, but they may be considerable.

The elements of recurrent expense are considerable. They include the cost of keeping up the system of accounts and records prescribed by the Commission, the cost of making the periodic and special reports required by the Commission to be made to it, the cost of accountants' services for periodic audits, and the cost of periodic reports to stockholders.

Another very serious element of increased recurrent expense I have already pointed out in the discussion about selection of directors. If the intricate rules of section 10 are enacted we shall have a very

serious problem with respect to the personnel of our board of trustees. The type of men we want on our board, whether they be present incumbents or replacements, will have to sacrifice other connections, and I don't see how we can expect them to do that without substantially increasing the extremely modest compensation which they are now willing to acept.

Section 17 (g) (2) gives the Commission authority by rules and regulations or order to require that any person be bonded in such minimum amount as the Commission may prescribe. It is obvious that the recurrent cost of any such bonds would ultimately have to be borne by the security holders. It is entirely conjectural how much such bonds would cost, but it might well be very considerable. Moreover, in general it is likely that such bonds will be proportionately more expensive in the case of smaller investment companies than it is of large ones.

I estimate that the annual expense of operating the trust, if the above-mentioned provisions are adopted, will be increased from 25 to 30 percent in our case.

As to the effect of the bill upon financing of small companies and underwriting other securities by investment companies, members of the Commission and of the staff have stated a number of times in the press that they consider that American investment companies, or at least some American investment companies, ought to supply equity capital to industrial concerns by way of underwriting or sales of the securities of such concerns and by way of purchasing such securities for investment. They have adverted to the fact that some of the British investment trusts perform these functions.

As I have already indicated, I believe that there is a place in the national economy for investment companies performing these functions. The four corporations which were the predecessors of Consolidated Investment Trust participated in underwritings and invested equity capital in industrial concerns. Our indenture of trust authorizes the trustees to do both and, as I have shown, we have taken considerable interest in the so-called "special situations" which I have discussed before. Although we have never participated in underwritings, we have given considerable thought to that subject.

The proposed law, despite the Commission's stated views, does not encourage an investment company to engage in financing special situations or to engage in underwritings. I have already indicated the serious problems raised by section 10 (e) so far as investments in special situations are concerned. I do not believe that we would start or that we ought to start making any investment of our shareholders' money in any special situation unless we were able to have one of our trustees go onto the board of directors of the special situations company. If we should decide to go into any underwriting it would probably be in relation to some company of relatively small size. I think we would generally be unwilling to participate in such an underwriting unless in connection therewith we would be able to have our nominee on the board of such company and generally we would wish such nominee to be one of the trustees. Such supervision of the management would be desirable from the viewpoint of persons who might purchase the securities which we underwrote or sold. And yet, under section 10 (e), if we own securities in any

company but do not have 5 percent of the voting securities, one of our trustees cannot go on the board of that company.

Moreover, it seems clear from section 15 (a) and section 19 (a) that the draftsman did not expect any investment company to engage in underwriting. Underwriting profits are apparently excluded from ordinary income and dividends from underwriting profits must be treated as if they were distributions of capital. This is clearly unsound.

The four points which I have touched upon set forth the principal specific points in the bill which will adversely affect our shareholders.

I would fail in my duties to my shareholders if I allowed this committee to think that if these foregoing points were properly dealt with this bill would be suitable for enactment. The general objections to the bill have been very ably indicated by Mr. Bunker, Mr. Quinn, and others, and it does not seem appropriate for me to take up more of your time to go over this ground again.

If I or my associates can in any way serve a constructive purpose to this committee in any problems which may confront you in determining the final disposition of this bill, you will find us anxious to cooperate and be useful and our efforts will be honest and sincere.

Senator Hughes. Thank you, Mr. Anderson.

How many more witnesses are there to be heard?

Mr. Griswold. I think we are about through, Senator.

Senator Hughes. Mr. Motley will want to go on on Monday morning.

Senator Herring. I wonder if the brief of the last one on the list could not be placed in the record. There is nothing to be gained by reading it to only two members of the committee.

Senator Hughes (presiding). When we take a recess today it will be until 10:30 next Monday morning.

Senator Herring. I suggest that we do that at this time.

Mr. Griswold. That is very satisfactory.

(Whereupon, at 12:30 p. m., a recess was taken until Monday, April 22, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

MONDAY, APRIL 22, 1940

United States Senate,
Subcommittee on Securities and
Exchange of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on Friday, April 19, 1940, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner, presiding.

Present: Senators Wagner (chairman of the subcommittee), Maloney, Hughes, Herring, Downey, Townsend, and Taft.

Senator Wagner. The subcommittee will come to order. Mr. Warren Motley is the first witness, I believe.

Mr. Motley. Yes, Mr. Chairman. Shall I sit here and go ahead?

Senator Wagner. Yes, we will now proceed.

STATEMENT OF WARREN MOTLEY, COUNSEL, MASSACHUSETTS INVESTORS TRUST, BOSTON, MASS.

Mr. Motley. My name is Warren Motley. I come from Boston. I appear here as counsel for the Massachusetts Investors Trust and Supervised Shares, Inc., the latter company under the same management.

I think I ought to mention that I and my firm are also counsel for several other investment companies in Boston, both open-end and closed-end, although I am not appearing for them today.

I am not going to take long to present what I have to say, and will confine myself almost entirely to section 10 of the proposed bill. I had intended to make a rather exhaustive discussion of section 10, but so much has been said on the different phases of it that I am going to limit myself, first, to bringing out one more concrete actual example of what it would do in a certain situation, as a supplement to the examples which have been brought out by the witnesses who have heretofore appeared before you; and then, after that, I propose to make a brief analysis of the different types of control which it seems to me that section seeks to cure—or I will correct that word "control" and say, different types of conflicts.

Now, before getting into that I am going to ask you to forgive me if I take up a little point which came up in Mr. Anderson's testimony on Friday, when you, Senator Wagner, were not here.

Mr. Anderson, president of the Consolidated Investment Trust, was testifying on Friday and he pointed out that in the case of his company he had an executive committee of three, and that it would be unlawful if he should at any particular time have on that executive

committee of three, two of his directors who happened to be wardens of the same church.

I do not wonder that Senator Hughes, who was presiding, expressed a little incredulity and very courteously suggested to Mr. Anderson that he thought he was going a little far. I think it is really worth while to take just a moment to point out that Mr. Anderson was absolutely right.

Section 10 (a) says that no company shall have a board of directors or executive committee more than a minority of the members of which consist of affiliated persons of any one company other than the investment company in question.

Now, Mr. Anderson's remark did sound a little bit far-fetched. But if you will look at the definitions in the bill you will find, on page 85, that a company means a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons whether incorporated or not; and affiliated persons are defined in the bill so as to clearly include directors of any company. And then in order to know what directors are you are referred to the provision on page 86 of the bill that "director" has the same meaning as in the Securities Exchange Act of 1934.

Now, if you will look at the Securities Exchange Act of 1934 you will find that the term "director" means "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

Now, certainly the wardens of a church are directors under that definition in the Securities Exchange Act of 1934. A church is certainly a company within the definition of "company" in this bill.

So I think I am perfectly safe in saying that Mr. Anderson's statement was entirely correct, that it would be unlawful for him to have two wardens of the same church on his executive committee of three.

Now, I do not want you for a moment to think that I would take this much time merely to be facetious or to bring out an absurd situation. I take the time because it seems to me a good example of two things.

1. How very far this bill goes in all sorts of unexpected ways as well as those which are clearly obvious; and

2. What a meticulous analysis of every word and section of this bill is necessary for anyone to understand what it means or how it will affect a particular situation. And it is simply for that purpose that I bring out that that particular point, not because it is particularly likely that anyone is going to be embarrassed by that actual situation.

I think the very intricacy of this bill is sufficient in itself to condemn it as a piece of legislation.

Now, gentlemen of the subcommittee, if I may I will take up the particular concrete example which I mentioned, which is just one more example supplementing those that have been given you by others. It relates to the situation of the two clients whom I represent here, Massachusetts Investors Trust, and Supervised Shares, Inc.

Massachusetts Investors Trust has a board of five trustees. They have no management or advisory contract with themselves or anyone else. These five men also constitute the board of directors of Supervised Shares, Inc., a Delaware corporation, which also has no advisory or management contract. These five men give practically their

whole time to the management of these two companies. They have quite a substantial research and statistical organization, which is shared by the two companies so that only a small proportion of the expenses falls on the little company. The Massachusetts Investors Trust has assets of $120,000,000, and Supervised Shares, Inc., has assets of only $8,000,000.

Each company also has an advisory board of five men, completely independent of the trustees. The same five men serve on the advisory board of each company. In fact, I think three of these men have appeared before you already.

Senator WAGNER. Mr. Motley, might I ask you a question right there in order that I may understand the situation?

Mr. MOTLEY. Yes, sir.

Senator WAGNER. You spoke about your company and then said it has five trustees. Just what is the organization there? Are the trustees appointed by the corporation, or did you mean to say that they were to be the directors of the corporation, or what is the structure?

Mr. MOTLEY. Let me make that clear. I am speaking of two companies as defined in the bill. One of these companies is in fact a strict trust, the Massachusetts Investors Trust, which has five trustees, who are self-perpetuating. The other company is a Delaware corporation, which has five directors, who are the same individuals and who are annually elected by the shareholders.

Senator WAGNER. I wanted to get your view of the situation.

Mr. MOTLEY. The advisory board of five men acts in that capacity both for the trust and for the corporation.

Senator WAGNER. They are other individuals again.

Mr. MOTLEY. They are five other individuals.

Senator TOWNSEND. What authority has the advisory board?

Mr. MOTLEY. The advisory board has no authority to determine that any investment shall be bought or sold. In the case of the Massachusetts Investors Trust the advisory board has some veto power; they can veto the placing of a new security on the approved list, but the approved list is a much larger list than the actual list of investments.

Senator TOWNSEND. What are their real duties?

Mr. MOTLEY. Their real duties are purely advisory and consultative

Senator WAGNER. Do you pay them by their attendance at meetings?

Mr. MOTLEY. I might add this, that in the case of Supervised Shares, Inc., the little company, the set-up is such that the advisory board has no authority whatever.

Senator TOWNSEND. What I am trying to find out is this: Of what benefit are they if they have no authority?

Mr. MOTLEY. They are purely advisers.

Senator TOWNSEND. I know, but if they have no authority what is their benefit to the company?

Mr. MOTLEY. The board of trustees, or I mean the board of directors gets the benefit of the advice and experience of these men to guide them in their actions.

Senator TOWNSEND. Are they paid anything for their advice?

Mr. MOTLEY. They are paid a portion of the percentage which goes to management. That is, a portion of what would otherwise go to the trustees is paid to this advisory board.

Senator WAGNER (chairman of the subcommittee). All right. You may proceed.

Mr. MOTLEY. Now, that is the set-up of the two companies. This advisory board has no authority to determine that any investment shall be bought or sold. In the case of Massachusetts Investors Trust, it has some veto powers. In the case of Supervised Shares, it is wholly advisory. This seems to me a good set-up. The little company gets a type of management which it could not command if it stood alone, and the same is true of the research and statistical facilities.

Now, we don't really know the status of the advisory board under this bill, so for the moment I am going to ignore them and assume that the five trustees of Massachusetts Investors Trust constitute the board of directors of each company.

Now, in speaking of the effect of section 10 here I am first going to ignore the advisory committee, because frankly we do not know what constitutes an advisory committee under this bill; and I will come back to that a little later. So we will assume that the five trustees of Massachusetts Investors Trust, these five individuals, constitute the board of directors of each company for the purposes of this bill. That, of course, is clearly forbidden by section 10 (a) of the bill. Even if they added six independent directors to the board of Supervised Shares, it would be forbidden. They must either add six independent directors to both boards or else three of the five must resign from Supervised Shares and three new men be substituted for them. Neither of these arrangements would offer much incentive to a continuation of the existing cooperation, and it is more likely that the five trustees would eliminate themselves from Supervised Shares, leaving it to find a new management.

We have also considered whether anything could be worked out through an investment advisory contract. If the five trustees of Massachusetts Investors Trust formed an investment advisory company in order to enter into an advisory contract with Supervised Shares, that again would be forbidden even though Supervised Shares had a wholly independent board of directors. If they undertook to form a management company which should act as investment adviser to both companies, this would be permissible only if they installed an independent majority of directors in both companies, and even then the combined assets of the two companies would be so close to $150,000,000 that they might run over that figure at any time, and so even that arrangement would become illegal. Moreover, Supervised Shares should have scope to grow, in the interests of its own shareholders. For, although now with assets of $8,000,000 it has an expense ratio which compares very favorably with the averages of other similar small companies, it would have to be considerably larger to get its expense ratio down to a point at all comparable to that of Massachusetts Investors Trust.

Now, of course, we could offer an amendment by way of a further exception in section 10 (b) which would permit some one of these arrangements, but, frankly, I hesitate to suggest any further complication of section 10. The whole trouble goes back to the particular prohibition of section 10 (a), which I believe to be wholly unjustified.

And yet, it would be most unfortunate if Supervised Shares should be cast adrift. It was orphaned once before and the trustees of

Massachusetts Investors Trust took it under their wing. It has had, at relatively small cost, all the advantages of management that the larger company has had. Any attempt to place it under any existing competent management would be fraught with the same difficulties. It would either have to be taken over by an entirely new and untried management, merged with some other company, or liquidated.

In the foregoing discussion, I have ignored the advisory board, as I said I was going to in this discussion of the effect of section 10, although it is a very important element in this set-up. I have done so because I don't know, under this bill, whether the members of that board are to be deemed directors of either company or both, and if they are to be deemed directors, I don't know whether, for the purposes of computing majorities and minorities, the five trustees and the five members of the advisory board constitute one board or two boards. At any rate, practically all of them would be disqualified under section 10 (e) because of holding directorships in companies which either are or well might be issuers of securities held in the portfolio of one or the other of the two investment companies. There is also the possibility that the members of the advisory board might individually be held to be investment advisers, which would lead to a lot of other complications and subject them all to the requirements of title II.

I don't know how many other companies have advisory boards of this kind—some I think do but probably not many. But it seems to me a very sound arrangement, centralizing responsibility in a small working board of directors or trustees and yet giving them the benefit of independent advice and criticism. Moreover, there can be no possible incentive to place on such a board men who would not be wholly independent and helpful. If any bill is to be adopted which attempts to specify who can or cannot hold certain positions, recognition should be given to members of such a board, and their classification clarified. My own opinion is that they should be classified separately, that they might well be required to register, if directors are so required, but that they should not be subject to the other rules or requirements applicable to either directors, officers, or investment advisers, because their functions are very different from those of either directors, officers, or investment advisers.

Now, that concludes my exposition of this particular concrete example of the practical difficulties in an existing situation, which seems to be a wholesome one, which would occur if section 10 were enacted into law.

Now, very briefly I am going to make a little statement which constitutes an effort I have made to analyze the points of conflict, the different kinds of supposed conflicts, which give rise to this whole question of independent directors under section 10:

1. Conflict with management company: If you have a real management company, i. e., one which is empowered by contract to make decisions, which I think is a very rare situation, then the management company really constitutes the management of the investment company and I do not see what function independent directors could perform.

2. Conflict with investment adviser: The common type of so-called management contract is with a corporation or firm which acts in the capacity defined in the bill as "investment adviser," i. e., its recom-

mendations require action by the board of directors to become effective. That is the common type of the so-called management contract. In this situation, I don't question the fact that independent directors of character and sound judgment might be useful, but I fail to see any essential conflict of interest between the company and the investment adviser to justify the mandatory requirement that some of the directors shall be independent of the investment adviser.

3. Conflict with portfolio companies: This point has been so thoroughly discussed that if the members of this committee are not already convinced that any restriction in this case is unwise, I do not believe anything I can say will be of very much help. Mr. Adams spoke on that subject, and a number of other men have spoken on the same subject.

Senator WAGNER. Let us suppose that a director of an investment trust is also a director of a concern in which the investment trust, we will say, owns a 40 percent interest, or has in its portfolio 40 percent of the investment trust's entire portfolio, do you think nevertheless there would be no conflict of interest there at all?

Mr. MOTLEY. You are now assuming that 40 percent of the assets of the investment trust are in it?

Senator WAGNER. Exactly, are invested in a company which has on its board a director of both companies. Do I make myself clear?

Mr. MOTLEY. You do. But I think you could have there two very different situations. If a small investment company, for instance, had invested 40 percent of its assets in the stock of the General Electric Co. it would only be a drop in the bucket so far as control is concerned. On the other hand, if it invested 40 percent of its assets in a small industrial company so that it had perhaps control of the small company, in that latter case they would be permitted to have a director on the board as this bill is drawn, but in the former case they would not be permitted to have a director on the board, I mean in the case of the General Electric Co. I do not really see so far as any possible conflict is concerned that it makes very much difference what percentage of the assets of an investment trust is invested in the securities of the other company.

Senator WAGNER. I want you to understand that my mind is entirely open on this and that I am merely asking the question for information. Let us suppose it is a large investment trust, say an investment trust of $300,000,000, and 40 percent of its assets are in the stocks or securities of the General Electric Co., taking your example again. That would be a very substantial sum of money, but nevertheless you see no conflict there, where one of the directors is on the board of both corporations.

Mr. MOTLEY. I do not see any conflict there that is objectionable. If that investment were big enough to constitute more than 5 percent of the voting stock of the General Electric Co. this bill says they can have a director.

Senator WAGNER. Well, I was not thinking of the bill for the moment but was getting your view of that factual situation.

Mr. MOTLEY. I see. You are testing the matter without any reference to the bill?

Senator WAGNER. Yes.

Mr. MOTLEY. Why, I should think it would be quite proper and desirable if an investment trust had any such large proportion of its

assets in one company for it to have a director on the board; I mean, to follow the affairs of the company in which it had invested such a large proportion of its assets. Looking at it the other way round, from the point of view of the industrial corporation, certainly it would seem that a particular stockholder, namely, an investment company which had such a large investment, ought to be represented and might properly be represented on its board of directors.

Senator WAGNER. Thank you. You may go ahead with your statement.

Senator MALONEY. What board do you mean?

Mr. MOTLEY. In that last reply I meant on the board of the industrial company.

Senator DOWNEY. There could not be any diverse relationship arise out of such a position, do you mean?

Mr. MOTLEY. I do not see how there could, Senator.

Senator WAGNER (chairman of the subcommittee). You may proceed with your statement.

Mr. MOTLEY. My next item is—

4. Conflict with other investment companies: This situation may well be subdivided into (a) conflicts with other companies in the same group; and (b) conflicts with other companies not in the same group. By the word "group" I mean two or more investment companies under the same general management. I am not speaking of systems. In both of these situations the alleged conflict is that directors having this common affiliation may tend to favor one company in which they are interested over another company in which they are interested. The only specific instance of favoritism as between these two companies having common directors that has been suggested, so far as I can recall, is that preference might be given to one company over another in the placing of orders for the purchase or sale of securities. In the case of group companies having the same executive management, this difficulty can easily be overcome by prorating each purchase or sale order among the companies. Where the executive management of the two companies is distinct, there can at least be no purposeful discrimination, and it would seem that any accidental advantage that one might obtain over the others at a particular time is hardly to be considered an abuse which merits legislative action. It might happen that the executive management of one was quicker than the executive management of the other, but that would be no purposeful favoritism on the part of the common directors.

5. Conflict with investment bankers: In considering this situation, I assume that purchase-and-sale transactions between an investment company and any of its directors, or any firm with which such director is affiliated, acting as principal, is prohibited, as is contemplated by section 17 of the bill. The general principle of such a prohibition seems to be pretty unanimously favored by everyone who has testified here. There may be some criticism of some of the details of section 17, but I do not think we have heard any criticism of the general principle that self-dealing should be prohibited. That in itself removes the primary conflict of interest. In addition, there are said to be possible conflicts in connection with underwritings, even in the absence of direct dealings between investment company and investment banker. Subsections (f) and (g) of section 10, on page 26 of the bill are intended to eliminate these conflicts. I do not want to go into

the details of these. There has been some criticism of these provisions, some of the witnesses indicating that they thought they went a little too far in the matter of restraining underwritings, but if the conflict in connection with underwriting is removed, in that or some similar way, then it would seem to me that the necessity for legislating against interlocking between the investment company and the investment banker does not exist. If, on the other hand, even though direct dealings are forbidden, it is desired to permit more freedom in the matter of participation in underwritings; then it may be wise to require that the investment company shall have some directors who are independent of the investment banker. The necessity of that, it seems to me, would depend very largely on the other provisions prohibiting certain types of dealings.

6. Conflicts with "underwriter": I use the word "underwriter" in the sense in which it is used in the bill, meaning what we generally term "the general distributor" in the case of an open-end trust. It has been clearly brought out in the testimony that in the case of a great many open-end companies the underwriter or general distributor is closely affiliated with the management, and several witnesses have testified as to the advantages of that arrangement.

I particularly recall the statement of Mr. Parker, of Incorporated Investors. He testified a few days ago as to the identity of distribution and management in his set-up, and of the advantages which he thought were absolutely obtained for the shareholders from that relationship.

If your committee is satisfied that there is no sound reason for requiring a separation of the functions of distribution and management, and if you agree with the opinion I have already expressed as to the absence of essential conflict between the investment company itself and its management company or investment adviser, then I think it follows that there is no sound reason for requiring that the investment company shall have a majority, or even a minority, of directors who are unaffiliated with the underwriter.

Here, again, I say that some completely independent directors, independent of the underwriter, may well be useful, if you get the right kind of men, but that I doubt very much if it is wise or necessary to require by law that there be independent directors, because I do not think there is a real conflict of interest.

Senator Wagner. As you know, a great many of those who have testified here have expressed the idea that they think it desirable to have some independent directors.

Mr. Motley. Independent of the distributor?

Senator Wagner. Well, no. I guess I am mistaken about that. The testimony related to another matter.

Mr. Motley. The whole purpose of my——

Senator Wagner (interposing). Would that not be desirable?

Mr. Motley. I think some independent men, of the right judgment and character, are always bound to be useful. But that is a very different thing from saying that there is an essential conflict which requires independent men. I think you will find in most cases that there are actually men on boards of directors who are wholly independent of the distributor. I am very sure that in Mr. Parker's case, for instance, where there is identity of management and distribution,

nevertheless he has some wholly independent men on his board of directors.

Senator WAGNER. But you do not think in any case there should be a provision of law requiring independent directors in the operation of an investment trust.

Mr. MOTLEY. Senator Wagner, my purpose in making this analysis was really to bring out that you do not get anywhere when you merely talk about independent directors in general, that you have really got to analyze it to see just what particular conflicts you are dealing with. I think there is a lot of difference there.

Senator WAGNER. All right. You may proceed.

Mr. MOTLEY. I have only a couple of pages more.

7. Conflicts with brokers: The alleged abuse in connection with this situation is that a broker who dominates an investment company may encourage or create trading in-and-out of investment securities to make stock-exchange business for himself. Whether there are actually any cases of domination by brokers I do not know, but there has been a good deal said about that possibility. Probably the best real safeguard against this abuse would be to require periodic disclosure to stockholders, as well as disclosure in the prospectus, of the existence of the affiliation, the proportion of the stock-exchange business handled by the broker in question, and the amount of commissions paid to the broker by the company—a matter of publicity.

8. Conflict with banks: I do not recall that any evidence has been offered as to any abuse arising out of this situation. In the absence of such evidence it would seem as if a group of men, all directors of one bank, might very appropriately be the directors of an investment company. Apparently, the drafters of this bill were not much concerned about this possible conflict, because by section 10 (b) (2) existing situations of this sort are permitted to continue by specific exceptions.

9. Conflicts with companies or institutions which have no connection with the investment company picture: I think it has been sufficiently brought out that the mere fact that more than a minority of the directors of an investment company are affiliated with some one company or institution which has no points of contact with an investment company, cannot give rise to any conflict, and that there is no possible reason for legislating against such a situation. Our churchwarden case, and many other cases which are analogous to it, will prove that.

That concludes the analysis which I have tried to make, about section 10, and to separate the different types of conflicts which the bill apparently was seeking to control.

My own conclusion, from the foregoing analysis, is that all of the restrictions contained in subsections (a) to (c), inclusive, of section 10, may safely be eliminated and should be eliminated. I believe that the conflicts which they seek to prevent either do not exist or can much better be cured by prohibition of certain direct dealings plus certain requirements for publicity along the lines which I have indicated. I also believe that the restrictions imposed by these subsections would be extremely harmful, for reasons which have been abundantly brought out in the testimony of others. And, finally, I doubt if the type of restriction imposed by section 10 would actually be effective to cure the abuses which they are aiming to cure.

Senator WAGNER. Does your company issue redeemable certificates or stock or whatever they may be?

Mr. MOTLEY. Both companies which I am representing here today, Massacusetts Investors Trust and Supervised Shares, Inc., are open-end companies, issuing redeemable shares.

Senator WAGNER. I take it you heard some testimony here on the question of dilution?

Mr. MOTLEY. Yes, sir.

Senator WAGNER. Do you not think that there is a situation that might give rise to improper practices?

Mr. MOTLEY. Senator Wagner——

Senator WAGNER (interposing). Let me be a little more specific in my inquiry and then you can direct your answer to it: The testimony given here was that you fixed each day the value of the shares of a particular investment trust—and I suppose that practice is followed generally—and that that is the shareholder's proportionate share of the investment trust.

Mr. MOTLEY. That is right.

Senator WAGNER. And that that price remains fixed during the entire day, isn't that so?

Mr. MOTLEY. The price is normally fixed at the close of the stock exchange on each day. That is the price which under the practice has been in effect during the whole of the following day, although recently some companies have established a new practice, that of fixing the price again in the middle of the day, so as to do it twice a day.

Senator WAGNER. Let us take a company which fixes a price you say at the end of the day—after the close of the day, is it?

Mr. MOTLEY. It is taking the closing prices of the stock exchange.

Senator WAGNER. And that price remains fixed during the entire day following, although your assets may, because of increase in value of the stocks, go up considerably.

Mr. MOTLEY. That is right.

Senator WAGNER. So that actually if you buy stock in the middle of the day, assuming that increase to have taken place, you are buying stock which is cheaper than the interest represented.

Mr. MOTLEY. That is right, as of that particular moment.

Senator WAGNER. Yes; as of that particular moment. So that goes on toward the end of the day. It is alleged, and I am entirely dependent upon the testimony, that insiders know that that price tomorrow morning is going to be higher, because they have watched prices go up, I mean prices of different securities that are held. They have that information, and toward the end of the day they buy in a considerable number of shares and therefore have a sure thing proposition, and they make a so-called insider's profit. Now, if that is possible is there some way by which we can prevent that sort of thing by the inside trader? It does dilute the assets, and to that extent I think it is an injustice to the present shareholders.

Mr. MOTLEY. Senator Wagner, it has been brought out that the outsider, who has to pay a load or selling commission on top of liquidating value, has no incentive or possibility of doing that because the rise in the market in a day would never be nearly enough to let him out with his load.

Senator WAGNER. Well, right there—but never mind. You may state your view.

Mr. MOTLEY. Let me make that a little clearer if I can, and I would like to make it clear. If the price is fixed as of the close tonight on a basis of $20 liquidating value, and I, being an ordinary investor, want to buy some shares the next day, I have to pay $20 plus a load, which load averages perhaps 7 percent, which would be $21.40 if my arithmetic is right.

To do what you suggest, to buy at the price at the close and then turn it back at a higher price, would not be possible unless the market rose at least 7 percent.

Senator HERRING. Is not that load fixed from day to day? Is not that part of the fixing of the price each day? Therefore it does not change the margin as between one day and another. This 7 percent always follows, does it not?

Mr. MOTLEY. Yes, Senator Herring; but you pay the 7 percent load when you buy in. You do not get the 7 percent load back when you redeem.

Senator HERRING. Is not that reflected in the price of the shares from day to day, though?

Mr. MOTLEY. Not in the redemption price.

Senator HERRING. It is not in the redemption price?

Mr. MOTLEY. No, sir.

Senator WAGNER. There is testimony in the record to the contrary that has been presented here by experts, to the effect that vast profits were made because of inside information.

Mr. MOTLEY. I have not really answered your question yet. That was preliminary.

As far as insiders are concerned, the State regulation which has been spoken of as Q3 to which at least 80 percent of the open-end trusts are now subject, now forbids selling shares to anyone except the general distributors and dealers at a price less than the price to the general public. That is why I brought out this point, that the general public cannot take advantage of the situation which you have mentioned. Under that regulation, which I think is a good one, it is forbidden to give a lower price to anyone inside the company. The distributor of course, buys at the flat liquidating value, because he has got to put on the load to pay his expenses and make his profit. The dealer to whom the distributor sells in turn pays a price somewhere between the price which the distributor pays and the price which the public pays.

There is the theoretical, perhaps actual, possibility of the distributor or the dealer taking advantage of the situation which you point out. In well regulated trusts the distributor is forbidden by his contract to do that. He agrees to use his best efforts and does use his best efforts to prevent any dealer from doing it. That is a situation, however, which we all recognize and which, as Mr. Traylor suggested, we feel could best be regulated under the Maloney Act by reason of the fact it is a situation which can only be availed of by distributors and dealers, all of whom are necessarily members of the association created under the Maloney Act.

Senator WAGNER. Of course we are not legislating here for responsible, legitimate operators, because they do not need any regulatory legislation. All of this legislation—I need not argue that with you—is because of abuses that exist by reason of irresponsible operators, and

it is those abuses that we want to prevent. The mere fact that you have adopted that regulation shows the possibility that abuse does exist, and you are trying to meet the situation.

Mr. MOTLEY. That is right, Senator. But our suggestion is that what we have done in policing ourselves can be done very well and logically under the Maloney Act, through the association.

Senator WAGNER. Somebody has referred to it as the Maloney association.

Mr. MOTLEY. Yes.

Senator DOWNEY. I would like to inquire what are the items making up that load that you speak of, of 7 percent. Did you call it load?

Mr. MOTLEY. Yes.

Senator DOWNEY. What are the items that make that up?

Mr. MOTLEY. The liquidating value of a share is fixed at the close of business every day. That is the price which the investment company itself gets. It gets cash based exactly, or as nearly as it is possible to base it, on liquidating values. The people that sell those shares have to make a profit and have to pay their expenses. So the load is a surcharge, you might say, added to the liquidating value. The investor pays liquidating value plus load, which averages about 7 percent, I think; and that load is divided between the general distributor and the dealer in such proportions as they may agree upon among themselves, and it goes to cover their selling costs and their profit.

Senator WAGNER. We have some testimony, too, as to abuses in regard to loads. They run as high as 18 to 20 percent in some of these very large trusts. You heard that testimony, I take it?

Mr. MOTLEY. I have heard the question asked of some witness, whether he thought 20 percent was too high, and he certainly admitted that he did. I do not know what the highest load in an open-end investmen trust is. It is nothing like that, I think. I remember Mr. Traylor testifying that it averaged about 7. We also think that competition goes a long way to control that. We also think that that is a matter which concerns the dealers and the distributors and which could very well be handled under the Maloney Act.

Senator WAGNER. There is testimony, as I recall very distinctly, that they did, in some of the operations of some very large investment trusts, charge as high as 18 or 20 percent. It was in relation to testimony given that the investment had to earn 20 percent before the investor could even get his money back.

Mr. MOTLEY. I think that must have been in connection with some of these partial-payment plans, or something of that sort.

Senator WAGNER. Yes; I think it was a partial-payment plan.

Mr. MOTLEY. I think someone testified that actually it was not possible to make a living selling to these very small buyers and keep the load down to a bare minimum amount.

Senator WAGNER. I cannot view it with indifference. With all due respect, I think it was an outrageous practice to charge small investors 20 percent as a load for the purchase of their securities. The testimony was that one of them was a rather large concern; and it was factual testimony, not probabilities at all.

Mr. MOTLEY. Senator, I do not want you for a moment to think that I am attempting to justify anything like a 20-percent load. I am

only saying that I do not recall that there was testimony as to anything like that except possibly in connection with a partial payment plan.

Senator WAGNER. Thank you. Are there any other questions?

Mr. MOTLEY. Senator, would you permit me to put one remark into the record?

Senator WAGNER. Certainly.

Mr. MOTLEY. Mr. Traylor has just sent me a little note which indicates that I made a slight misstatement which I did not mean to make. I said that the five directors of Supervised Shares were identical with the five trustees of Massachusetts Investors Trust. I had known that there used to be seven directors of Supervised Shares, but I had understood that the two outsiders had dropped off. Mr. Traylor now explains to me that there are still two directors on the board of Supervised Shares who are not trustees of Massachusetts Investors Trust.

Senator WAGNER. We know you intended to be accurate.

Mr. MOTLEY. It is not important, but I would like to put it in for purposes of accuracy.

Thank you, Senator.

(The following statements were submitted by members of open-end companies for inclusion in the record.)

STATEMENT BY S. L. SHOLLEY, PRESIDENT OF KEYSTONE CUSTODIAN FUNDS, INC., OF BOSTON, MASS., BEFORE SENATE BANKING AND CURRENCY COMMITTEE, ON THE WAGNER INVESTMENT COMPANY BILL

My name is Sidney L. Sholley. I am president of Keystone Custodian Funds, Inc., of Boston, Mass., which operates a group of mutual-type, open-end trust funds with a combined market value of over $23,000,000 under what is known as the Keystone plan, which I shall later briefly describe.

I am in favor of proper regulation. Proper regulation safeguards not only investors but the investment trust industry as well. An approach to the problem of regulation which would enact into law those principles widely accepted as being both sound and desirable would receive my wholehearted approval. The proposed bill, as drafted, not only covers these principles but goes much further. It seeks to mold investment companies of all types, true trusts as well as corporations, into predesigned patterns to an extent which, in my opinion, goes beyond what is necessary to attain the objectives desired. This will both needlessly complicate sound operation and materially increase expense to investors.

The Keystone plan, which I shall now briefly describe, came into being in 1932, near the low point of the long bear market, but has had its greatest growth during the past 3 years. It was the result of a careful study of the problems and requirements of the investing public and is a serious and, I believe, successful attempt to solve a number of these basic problems. For instance, it was recognized that the investment objectives of individual investors are different. One type of investor is primarily interested in safety of principal; another, maximum return on capital; still others in growth of capital. Different types of securities are needed to meet these different investment objectives. Accordingly, in the Keystone plan, the securities market, consisting of over 4,000 bonds, preferred and common stocks—listed on the New York Stock Exchange and the New York Curb Exchange, is divided horizontally into different groups or classes of securities. Good-quality bonds, medium-priced bonds, low-priced bonds, and speculative bonds; income preferred stocks and appreciation preferred stocks, quality common stocks, income common stocks, appreciation common stocks, and low-priced common stocks are all typed into their respective classes. There is a separate Keystone fund in each of 10 classes of listed securities, 4 funds in the different grades of bonds, 2 funds in preferred stocks, and 4 funds in common common stocks. Approximately $14,000,000 is invested in the bond funds, $4,000,000 in the preferred-stock funds, and $5,000,000 in the common-stock funds, a total combined market value of $23,000,000.

By means of this classification into different groups, the investor is enabled to select those types or classes of securities most nearly fitting his particular investment objectives. In addition he obtains broad diversification, from 30 to 70 securities in each Keystone fund, as well as constant supervision by an investment counsel organization which has been developed to perform the highly specialized work incident to the typing, classification and analysis of over 4,000 listed securities. While each of these Keystone funds is separate and distinct from the others, they are all part of the Keystone plan. Each fund is appropriately named to identify the type of security in the portfolio and the individual securities may be changed only through transfer of securities from the reserve lists for each fund, which are revised periodically by investment counsel and must be sent to all certificate holders before they become effective. All of the funds are operated by Keystone Custodian Funds, Inc., pursuant to trust agreements substantially identical in form. These trust agreements provide important safeguards to the investor, requiring, among other things, the custody of the securities and cash with a bank, the semiannual audit of accounts by public accountants and the selection and supervision of the securities by investment counsel, which is named in and is a party to the agreements.

In its work of typing, classifying, selection, and supervision, investment counsel naturally performs these services for all 10 Keystone funds, a circumstance obviously essential to the sound operation of such a plan, but which apparently would not be permissible under the bill as presently written. To require a different manager for each fund, as would apparently be necessary under section 10 (d), would create serious operating problems and would certainly increase expense to investors. There are other problems of a similar nature. For example, the trust agreement for each fund has a termination date in 1945. In order to provide a continuing service to investors, this date will have to be extended, or the funds replaced by others, but we might be restricted from so doing by section 11, having to do with the "recurrent promotion of investment companies." Similarly, should it appear advisable in the interests of investors to introduce additional Keystone funds including types of securities not presently covered by the Keystone plan, it might be difficult to do so under this same section 11.

In the typing of listed securities, the bonds, preferred stocks and common stocks of investment companies fall into different groups and in some instances might be attractive for use in the various Keystone funds. Since the trusts agreements themselves, as well as the practical limitations under the revenue act applying to mutual investment companies, limit the percentage that may be invested in the securities of any one company, the question of control does not apply in the operation of the Keystone funds. Yet section 12 of the bill would not permit the inclusion of listed securities of investment companies, no matter how attractive they might be.

One of the important objectives in the Keystone plan is to closely link the interests of investors and management throughout the life of the investment. It is felt that such a linking of interests is best achieved by compensating management in proportion to and at the time when the investor himself profits from his investment. For this reason the management compensation in the Keystone plan is based on a percentage—one-tenth of the appreciation or profit to each individual investor at the time he liquidates his interest. Should any net realized profits be distributed as capital distributions while his shares are held, a circumstance which might be necessary in order to qualify as a mutual investment company under the revenue act, and obtain the tax advantages thereof, the investor would receive nine-tenths and the management one-tenth of such net realized profits distributed. But otherwise management would receive nothing until the investor liquidates his certificate and then only if such investor realizes a profit over and above his original purchase price. In the Keystone plan, each fund is limited to a particular type of security, cash must be fully invested and buying on margin or borrowing is not permitted by the trust agreements. Thus, incentive to speculate to increase management fees, which presumably is the basic criticism of contingent compensation, does not apply. Section 15 (a) of the bill would require compensation of management to be based on a definite sum on money or an amount representing a definite percentage of income or of net assets. In other words, contingent fees are banned.

Section 15 (b) defines a "diversified investment company," one of the requirements being that its portfolio turn-over must not exceed 150 percent. The purpose of this ratio is obviously to measure the extent of voluntary trading in portfolio securities. This definition of turnover, as it now appears in section 45 (a) (30), however, does not measure voluntary trading but includes involuntary

or automatic transactions arising from the purchase or liquidation of trust shares by investors. To be accurate the definition of portfolio turn-over should cover only voluntary transactions and should exclude involuntary or automatic transactions as the management obviously has no control over purchases and liquidations of trust shares by investors.

In this brief discussion of the proposed bill, I have not touched on all the problems pertinent to Keystone Custodian Funds, but a few of the major ones. Certainly, such changes as may be made in the bill should take these problems as well as those raised by representatives of other investment companies into account. Unless great care is taken in studying all possible effects of the detailed definitions and regulatory provisions of the proposed bill, there are bound to be "accidental results" which work to the detriment rather than the benefit of investors, that handicap or destroy legitimate businesses and that acconplish no desirable or beneficial social result.

MEMORANDUM RELATIVE TO S. 3580 "TO PROVIDE FOR THE REGISTRATION AND REGULATION OF INVESTMENT COMPANIES AND INVESTMENT ADVISERS AND FOR OTHER PURPOSES"

(Prepared by Francis I. Amory, vice president, and E. Roy Kittredge, treasurer, of General Capital Corporation. Submitted to Senator Robert Wagner, chairman of the Senate Banking and Currency Committee, April 22, 1940)

This memorandum has been prepared by two of the principal officers of General Capital Corporation, an investment trust of the open-end management diversified type located in Boston, and is submitted to express the point of view of the management of the corporation.

GENERAL CAPITAL CORPORATION

General Capital Corporation is an outgrowth of Capital Managers, Inc., a privately owned investment company formed in 1927 by a group of five well-to-do Boston investors and a group of investment analysts. The object of the company was to develop an investment management organization which would be useful not only to the group but to each of the stockholders. Great care was taken, and always since has been taken, to make sure that nobody gained advantage at the expense of any stockholder from information obtained.

At the end of its first year, in May 1928, five more substantial investors joined the group and at about the end of its second year it was decided to form a publicly owned company.

Closed trust 1929–34

This company, General Capital Corporation, began business in August 1929, as a closed-end company. Over 29 percent of its capital was paid in by the management and their associates. Of this amount Capital Managers, Inc., invested an amount approximately equal to its paid-in capital. At the same time Capital Managers became General Capital's investment adviser and manager under a contract which could not be terminated except by mutual consent prior to December 31, 1934.

Open-end trust 1935 to date

At the end of 1934, by vote of stockholders, the original contract with Capital Managers was terminated and a yearly contract with Capital Managers was entered into. At the same time General Capital's charter was amended to require the company to redeem shares presented for redemption at liquidating value. Stockholders thus had the opportunity to vote on the new arrangement and then to redeem their shares if they wished to.

Although General Capital became an open-end company in December 1934, and registered with the Securities and Exchange Commission under the Securities Act of 1933 in March 1935, it was not until the fall of 1936 that it began actively to promote the sale of its shares to the public.

Present size and present management investment

At the present time, April 11, 1940, General Capital has approximately \$3,551,000 of assets at market value, 114,760 shares outstanding and 1,150 to 1,200 stockholders. Of the shares outstanding approximately 30 percent, with a

value of over $1,000,000, are owned by Capital Managers and the present directors and officers of both corporations or held by such individuals as trustee or cotrustee or held by wives and children of such individuals.

Management compensation

The management's compensation for its services (since the time when General Capital became an open-end company) is paid quarterly at the rate of one-eighth of 1 percent of the value of the assets at the beginning of the quarter. In addition directors receive directors' fees for attendance at meetings. The management is, and always has been, prohibited from participating in any profits which may be made from sales of shares.

Services and facilities provided by management

For the above compensation the management provides the company with its board of directors; a full-time research and administrative organization consisting of seven persons, and recently, in addition, the personal advisory services of one of the country's leading economists and of his staff of assistants; and office space, office facilities, etc. The management also relieves the company of all costs of qualification of its shares for sale under the Federal and State laws and all other costs relating to the sale of shares.

Directors

From the beginning a majority of the directors of General Capital have been important trustees and investors and their ownership of shares in the company has been substantial.

PRESENT REGULATION OF GENERAL CAPITAL

Information filed with the Securities and Exchange Commission

General Capital is registered with the Securities and Exchange Commission under the Securities Act of 1933 both as an issuer and as a dealer, and under the Securities and Exchange Act as a listed company on the Boston Stock Exchange. It has also been, and still is, subject to the investigation of investment trusts by the Securities and Exchange Commission.

A partial list of papers filed by General Capital with the Securities and Exchange Commission follows:

Date	Subject	Approximate pages
Under Securities Act of 1933:		
Mar. 19, 1935	Registration of shares for sale	40
Apr. 17, 1936	do	45
Feb. 23, 1937	Registration of shares for sale (amendment)	26
Mar. 19, 1935	Prospectus	16
May 11, 1936	do	20
Jan. 19, 1937	do	20
Jan. 19, 1938	do	16
Jan. 25, 1939	do	16
Dec. 12, 1939	do	16
Under Securities and Exchange Act:		
Aug. 12, 1935	Registration with the Securities and Exchange Commission for listing on Boston Stock Exchange.	42
Apr. 24, 1936	do	19
Apr. 27, 1936	Annual report to Securities and Exchange Commission and Stock Exchange.	28
Apr. 28, 1937	do	29
Apr. 26, 1938	do	30
Apr. 26, 1939	do	30
Under Securities and Exchange Commission investigation of investment companies:		
Mar. 24, 1936	Answers to questionnaire	115
Feb. 17, 1937	do	10
Oct. 14, 1939	do	5

Hearings before Securities Exchange Commission

On June 29, 1936, the treasurer of General Capital, at the request of the Securities Exchange Commission, testified at an informal oral investigation of General Capital, conducted by Dr. Gourrich and attended by Mr. Schenker and 10 or 15 members of the Securities Exchange Commission investigating staff, lasting all afternoon, after preliminary work lasting all forenoon. Later the treasurer and legal counsel of General Capital, at the request of the Securities Exchange Commission, attended a formal investigation of General Capital before Commissioner Healey.

A verbatim report of both of the above hearings was made by Securities Exchange Commission stenographers. We have seen, but have never had copies of, these reports. As we recall them they amounted to more than 100 pages.

Information filed with States

General Capital has qualified its shares for sale by registration in the following States: California, Indiana, Iowa, Maine, Michigan, Minnesota, Missouri, Ohio, Oregon, Rhode Island, and Washington. In connection with such registration most of these States require the filing of information concerning the company and its officers in great detail and require the filing of detailed annual or semiannual reports. They also require that the business be conducted in conformity with high standards.

An example of these standards is contained in Regulation Q3 from the Ohio regulations, which is substantially the same as the regulation approved by the National Association of Securities Commissioners. This regulation is very comprehensive and contains 25 specific requirements, restrictions and prohibitions. We understand that this regulation is being filed with the committee by an investment trust representative appearing before it. We should be glad to submit a copy of the regulation if desired.

Examiners from some of these States have examined General Capital at its office.

Record with Securities and Exchange Commission, with States and with stockholders

Insofar as General Capital, or we, have any knowledge neither the Securities and Exchange Commission nor any of the States have ever criticized or have ever found any cause for criticism of General Capital. No State has ever denied General Capital's application for qualification and the only State in which such an application has been withdrawn is Wisconsin, where technical problems have not yet been solved and where the official in charge has advised that he will do nothing further until the question of Federal legislation is settled. No dissenting vote has ever been cast at a stockholders meeting of General Capital Corporation.

Summary

We know of nothing in General Capital's history, in its dealings affecting stockholders, in its dealings affecting the public, in disclosures developed by Securities and Exchange Commission examiners and by State examiners, etc., which gives any basis for the view that any further Federal regulation of it is needed or would be advisable. There is ample evidence, on the other hand, that General Capital is burdened by existing regulation and that this regulation is already cumbersome and expensive.

We believe that proper, intelligent regulation is desirable.

NEED FOR FURTHER FEDERAL REGULATION

A tremendous mass of material has been prepared by the Securities and Exchange Commission from its investigations, extending over several years, for the purpose of establishing grounds for further Federal regulation of investment companies. These reports, however, are, in our opinion, one-sided. We believe that the industry as a whole is condemned on the basis of the sins of the sinners without any counterbalancing evidence of the merits of the meritorious.

Such a method of approach is, in our opinion, distinctly unsound as a basis for legislation.

We believe the Securities and Exchange Commission investigation should have been made from an impartial point of view and should have reported on the merits as well as the evils of the industry, and on the scope of present Federal regulation and present State regulation, and that such an investigation and report by an impartial body is necessary as a guide to sound legislation. It seems hardly

necessary to say that we believe the evils disclosed by the Securities and Exchange Commission reports should be stamped out by further Federal legislation if such legislation is actually necessary and if such legislstion will not on balance do more harm than good.

We wish to state that no invitation has ever been extended to us by the Securities and Exchange Commission to give the Securities and Exchange Commission our views regarding the proposed legislation and that a letter which we wrote to the Securities and Exchange Commission regarding the proposed legislation was not acknowledged. We were told about the proposed legislation by representatives of other investment trusts but were informed that if we wished to present our views to the Securities and Exchange Commission we would be prescribed and limited, and it seemed to us we would, therefore, not be able to make a proper presentation.

On the only other occasions when we offered suggestions to the Securities and Exchange Commission we had similar experiences. In the first of these a suggestion for making procedure much less cumbersome and expensive was passed over apparently without much consideration, and in the second our letter was not acknowledged.

These comments are not intended as criticism of the Securities and Exchange Commission's performance of its functions as a whole, for we realize that in many respects it has accomplished great and useful things, and that the Commission and its staff have in general labored hard with their superhuman tasks. The incidents we refer to, however, seem to us to indicate that any governmental body, with such far-reaching powers and responsibilities as the Commission now has, is bound to be rigid and slow in action, with resulting discouragement and uncertainty to businessmen who have to submit proposals for approval or other action If this bill were to add further duties and discretionary responsibilities to those the Commission now has, we cannot help but feel that its performance would be more hampered and unpredictable than it now is, and would interfere with the necessary process of simplifying and clarifying the laws and regulations under which the Securities and Exchange Commission now acts, to which we think the Commission should devote much more of its energies.

PRINCIPLES ON WHICH FURTHER FEDERAL LEGISLATION SHOULD BE BASED

If further Federal legislation is needed we believe it should be based on the following principles:

1. Investment trusts are desirable institutions and their development should not be stifled.
2. Investment trusts can for the most part be satisfactorily regulated by the States. They are not like transportation, food, etc., which must cross State lines. States can refuse to admit the securities of investment trusts if they so desire. The Federal Government should not force its will on the States in this field.
3. Regulation should be reduced to minimum needs.
4. The regulatory body should be specifically restricted by law and should have a minimum of discretion on specific matters, for definite purposes and within specific limits.
5. Regulation should not be cumbersome or expensive. It should not overlap and duplicate other Federal regulation.
6. The regulatory body should not be prosecutor, jury and judge or become an octopus.
7. The Federal Government should not continue to concentrate power in itself and in its agencies.

OUR OPINION OF PRESENT BILL IN GENERAL

Our opinion of the present bill in general follows:

1. The bill is based on extremely one-sided and unsound premises.
2. The bill fails to recognize the desirability of investment trusts and threatens the life of all trusts in its zeal to abolish the evils of a few.
3. The bill provides for a maximum of regulation.
4. The bill gives the regulatory body almost unlimited discretion.
5. The bill provides for regulation which would be extremely cumbersome and expensive both to the Government and to investors. The bill overlaps and duplicates present Federal regulation.

6. The bill gives tremendous additional and quite possibly conflicting responsibilities and powers to a Federal agency which is already overburdened with duties some of which might better be delegated to more than one body.
7. The bill unnecessarily forces its will on States.
8. The bill would encourage people to reply on the Federal Government and not on themselves to an undue degree.
9. The bill is an important and significant step toward further undesirable concentration of power in the Federal Government and its agencies.
10. The bill is so unsound in its general point of view and structure that we believe it would be impractical to try to revise it. We believe an entirely new bill, if a bill is desirable, should be written based on the principles which we have suggested.

THE BILL AS IT APPLIES TO OTHER THAN OPEN-END INVESTMENT COMPANIES

Although many of our comments on the bill in this memorandum are applicable from the point of view of the bill's treatment of all investment companies, the memorandum is intended primarily to cover, solely because of limitations of time and space, only certain phases of the subject which relate to open-end management companies.

THE BILL AS IT APPLIES TO OPEN-END COMPANIES

The remainder of this memorandum will confine itself to the bill as it applies to open-end management diversified investment companies which are capitalized solely with redeemable securities.

The definition of investment companies of this type in the bill (secs. 3, 4, and 5) is not correct as such companies now in existence are constituted. These companies are correctly defined as follows: "Open-end management diversified investment company" means an investment company which has outstanding or is offering for sale only redeemable securities of which it is the issuer, which has a board of directors or trustees which is entrusted by the stockholders with the management of the company and the investment of its funds, and which diversifies its investments according to the laws and regulations of the various States in which it offers its securities for sale.

Redeemable security is defined both in the bill and in this memorandum as follows:

" 'Redeemable security' means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."

Brief description of open-end management diversified investment companies

The type of investment company dealt with in this memorandum is designed to fill the investment management needs of the investor who (1) cannot, or does not wish to, manage his investments himself, and (2) cannot, or does not wish to, keep direct control of his investments and manage them with the advice, paid or unpaid of others. Most of these investors are people of moderate means and their average potential investment in any one investment company would be relatively small.

This type of company is a medium by which such investors are able to group their interests into a unit of sufficient size to enable them to get at reasonable cost qualified management and adequate diversification (which they could not otherwise have) with the same liquidity which they would have if they managed their investments themselves. In these respects these companies are somewhat similar to savings banks, cooperative banks, mutual insurance companies, etc.

If such investors were deprived of this medium they would be deprived of the means of obtaining satisfactory investment management and of obtaining adequate diversification. In our opinion there is no other way in which such investors can obtain satisfactory management, satisfactory diversification, and satisfactory liquidity except at prohibitive cost.

The relative importance of this type of company is indicated by the amount of sales of securities of this type of company from 1927 to 1936 and the proportion of all sales of investment company securities which these sales represented, shown in the following table. This table shows a very great increase in the sales of this type as compared with other types in the later years.

Sales of securities of open-end management investment compa

[Report of the Securities and Exchange Commission, pt. 2, vol. II, p.

Year	Sales	Percentages of total sales of investment company securities	Year	Sales	...urities
1927	$20,000,000	5.2	1933	$82,000,000	66.2
1928	40,000,000	4.1	1934	69,000,000	45.4
1929	89,000,000	2.9	1935	86,000,000	50.3
1930	29,000,000	3.5	1936	123,000,000	61.1
1931	22,000,000	6.6			
1932	26,000,000	21.0	Total	586,000,000	9.3

Different from other types of investment company

This type of investment company is different from other types. In this type of investment company the shareholders and the investing public are the masters and the company depends for its continued existence on confidence on the part of its shareholders and the investing public. By failure of the investing public to continue to purchase the securities of such a company or by redemption of the shares of such a company by its shareholders, or by a combination of both processes, liquidation of such a company could take place in short order. For these reasons these companies have a certain natural immunity to abuses. And for these reasons these companies, at least, are not properly a subject for legislation which does not clearly differentiate these companies from companies of other types.

Open-end management diversified investment companies are not subject to the shortcomings and abuses enumerated in the bill's "findings" and "declaration of policy"

That part of the report of the Securities Exchange Commission on investment trusts and investment companies entitled "Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies" (pt. 3), contains 2,124 pages, of which only 91 pages (pt. 3, ch. III, pp. 1 to 91), or about 4 percent directly relate to open-end management companies. These 91 pages are devoted almost entirely to "problems" relating to the sale of shares, as distinguished from "abuses" of the type specifically mentioned in the bill. The only substantial instance of abuse cited in these pages relates to an abuse which was eliminated when discovered by the Securities and Exchange Commission under the authority given by the Securities Act of 1933 and for which no further legislation is needed. These 91 pages give no substantial basis for the application of the "Findings" and the "Declaration of Policy" in this bill to open-end management investment companies. On the contrary these relatively few pages, representing the results of a vast amount of formal, detailed investigation of each company by the Securities and Exchange Commission, are convincing evidence that open-end management companies are already subject to adequate regulation and that these companies should be completely exempt from the provisions of the bill.

The "problems" outlined in the 91 pages referred to in the foregoing paragraph are of relatively minor importance and can be satisfactorily solved without further legislation. See pages 11 to 14 of this memorandum.

These companies are highly regarded by an increasing number of intelligent, experienced investors and are supervised by State regulatory bodies. They are not and have not been subject to a material degree, to the abuses which this bill is intended to mitigate or eliminate, as follows:

These companies do not "dominate and control * * * the policies and management of, companies engaged in business in interstate commerce" and have not done so in the past, other than in the interest of investors in their shares and then only to a minor degree as would be the right of any stockholder. (Quotations from the bill, sec. 1 (3).)

These companies do not "have a vital effect upon the flow" of the "national savings * * * into the capital markets." (Quotations from the bill, sec. 1 (4).)

These companies are subject to effective State regulation. (See the bill sec. 1 (5).)

I[illegible] do not "purchase, pay for, exchange, receive dividends upon, vote, [illegible] voting, sell, or surrender securities issued by" these companies [illegible] quate, accurate, and explicit information, fairly presented, concern[illegible] ter of such securities and the circumstances, policies, and responsi[illegible] companies and their management." These companies are all sub[illegible] sion by the Securities and Exchange Commission under the Secur[illegible] 933, subject to the general investigation of investment companies by the [illegible] rities and Exchange Commission, subject to the Securities and Exchange Commission through the National Association of Securities Dealers under the Securities Exchange Act, subject to laws and regulations of the various States, and subject to the necessity of dealing fairly with their shareholders if they are to keep their shareholders from redeeming their securities and thus liquidating the companies. (Quotation from the bill, sec. 2 (1).)

These companies are not "organized, operated, or managed in the interest of directors, officers, managers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders and of the public." (Quotation from the bill, sec. 2 (2).)

These companies do not "issue securities containing inequitable, discriminatory, or anomalous provisions, or fail to protect preferences and privileges of their outstanding securities." (Quotation from the bill, sec. 2 (3).)

These companies do not have "control or management" which "is unduly concentrated, inequitably distributed, or irresponsibly held." (Quotation from the bill, sec. 2 (4).)

These companies "in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities," do not "employ unsound or misleading methods," and they are "subjected to adequate independent scrutiny." (Quotation from the bill, sec. 2 (5).)

These companies cannot as a practical matter be "reorganized, dissolved," and cannot "become inactive or change the character of their business," and "the control or management thereof" cannot be "transferred, without the consent of their security holders and without adequate public supervision." (Quotation from the bill, sec. 2 (6).)

These companies cannot as a practical matter "engage in manipulative or unduly speculative transactions, have excessive investments in securities or property of a speculative or unmarketable character, or by borrowing and the issuance of senior securities[1] increase the speculative character of their junior securities." (Quotation from the bill, sec. 2 (7).)

These companies do not "operate without adequate assets or reserves, or attain such great size as to preclude efficient investment management and to have excessive influence in the national economy." (Quotation from the bill, sec. 2 (8).)

In short these companies have not been and are not now guilty of "the abuses enumerated in this section" (sec. 2) of this title. (Quotation from the bill, sec. 2 (8).)

Further Federal regulation of open-end management diversified investment companies is unnecessary and might be harmful

Further Federal regulation of these companies as proposed, in addition to that now provided by Federal laws, would in our opinion be expensive, impractical, unreasonable, and unnecessary, and would impede the operation of the economic system. Such regulation would duplicate and conflict with present effective regulation by the States and present supervision by the Securities and Exchange Commission under the Securities Act of 1933 and under the Securities Exchange Act of 1934. Such regulation might impair the operation, and impede the development, of this type of company and would be contrary to the national public interest and to the protection of investors. Such regulation would probably add unnecessary abuses which are inherent in Government restrictions and regulations which would more than offset any abuses which such regulation might be intended to mitigate or eliminate.

These companies are especially vulnerable to imputation of guilt, even though unfounded, because of the fact that investors may redeem their shares on demand

[1] Over 95 percent of the capital invested in open-end companies, we understand, is in companies having no senior capital.

and thus liquidate the companies and because of the fact that these companies are all relatively young and not many of them have attained sufficient size and standing to withstand such imputations. They are in this respect much like savings banks and insurance companies, but unlike savings banks and insurance companies these companies are not sufficiently old to have the standing in the public mind which savings banks and insurance companies have. A "run on the bank" can be started much more easily.

Passage of this bill without exemption to these companies, or failure to act on this bill, would do inestimable harm to these companies, to their present and prospective investors, and, to that degree, to the national public interest.

The extremely one-sided point of view of the bill

A one-sided point of view—in the bill and its sponsors—is shown in the "Findings" and in the "Declaration of Policy," sections 1 and 2 of the bill. This evidence of bias in itself should cast doubt on the soundness of the bill.

We believe the Securities and Exchange Commission is already overloaded with responsibilities, authorities, and duties, and we believe so much concentration of power in a governmental agency should be the subject of concern.

Although this bill might succeed in preventing some abuses which have happened with some types of investment and holding companies (many of which abuses were contrary to existing law or have been dealt with in existing State or Federal regulation), in attempting to add further checks on such abuses we believe the bill would substitute other evils equally bad, or even worse, unless drastically changed.

THE PROBLEM OF FAIRLY PRICING SHARES OFFERED TO THE PUBLIC

Securities and Exchange Commission has authority and responsibility on pricing under Securities Act of 1933

Although much has been made in the Securities and Exchange Commission's testimony before the committee of the problem of pricing, only one side of the problem has been presented and no constructive solution has been proposed by the Securities and Exchange Commission.

We believe the Securities and Exchange Commission has the authority and the duty to solve this problem completely and satisfactorily both in the interest of the public and of the investment trusts. We believe it is only the failure of the Securities and Exchange Commission to perform its duties under the Securities Act of 1933 which has permitted pricing abuses to exist to the detriment not only of investors but of investment trusts as well.

General Capital's prospectus states: "By reason of the execution of purchase orders on the basis of the previous day's close, on any day when the net value of the corporation's assets measured by market quotations has increased it will receive (and the investor will pay) for shares sold less than the proportionate part of such net value * * *. The corporation considers, however, that no material inequity to it or to investors results from this situation."

Other investment trust prospectuses contain somewhat similar statements. If the statements in these prospectuses are not true or are misleading it seems to us the Securities and Exchange Commission should either require that the prospectuses or the pricing methods be revised or should stop the sales of the shares.

Principles on which problem should be approached

We believe the pricing problem should be approached on the basis of the following principles:

1. Sale of shares is desirable from the point of view of both present and prospective stockholders of investment trusts as well as from the point of view of the management. Without such sales sufficient size cannot be attained or maintained to give stockholders satisfactory and economical management.

2. Asset value, or liquidating value, computed on the basis of last sale or bid prices does not represent the amount for which the assets could be purchased or could be liquidated at that particular time. Such value is only an approximation of the amount for which the assets could be purchased or liquidated.

3. Dilution measured by the difference between the price at which a share is sold and the asset value per share, based on the latest market quotations at the time of sale, is only approximate and is clear dilution only to the shareholder who liquidates his shares at that particular time. Such dilution is not likely to be greater than the accretion gained by the same shareholder when he

purchased his shares in the average case and, in any event, is not likely to be consequential in amount.

4. Dilution which is of real consequence, which is permanent, and which should be guarded against is measurable only by market quotations in the days, weeks and sometimes months after the sale takes place. In many cases "apparent" dilution becomes accretion, by reason of a decline in the market, at the first opening of the market following the sale which created the "apparent" dilution.

5. Permanent dilution or accretion takes place not when the shares are sold but when the cash proceeds are invested. This investment necessarily must take place after the sale and at different prices (unless there is a coincidence) from the prices on which the sale was based. Since the cash proceeds are not received for several days this investment ordinarily takes place at least several days after the sale.

6. Investment trust shares cannot be sold in the volume which is desirable in the interest of the public if an effort is made to completely eliminate "apparent dilution" by extreme restrictions of time and prices at which shares may be sold. The studies which follow show that such extreme restrictions are unnecessary.

General Capital's experience with pricing

Contrary to the impression which we get from the Securities and Exchange Commission's testimony and report, we believe most investment trust managements are conscientiously looking after the interests of their stockholders on the problem of pricing their shares. But if it should be conceded that managements are short-sightedly selfish General Capital at least offers an instance where the management has an interest in the trust which is so great (30 percent) that it is unlikely it would permit any material dilution to take place. In this case 30 percent of any dilution which takes place is suffered by the management.

General Capital has always watched closely for material dilution and following the occurrences in September 1939, it prepared detailed studies of its experience for the 3 years and 1 month from September 1, 1936 to September 30, 1939 (the entire period during which it had been actively offering shares for sale). These studies disclosed the following facts:

In 38.7 percent of the cases when there could have been "apparent" dilution and 39.0 percent of the cases when "apparent" dilution existed by reason of sales the "apparent" dilution disappeared and became accretion in 1 to 4 days.

In 57.2 and 56.5 percent, respectively, of the above-described cases the "apparent" dilution became accretion in 1 to 9 days.

In 66.4 and 64.1 percent of the cases the "apparent" dilution became accretion in 1 to 14 days.

In 69.4 and 69.0 percent of the cases the "apparent" dilution became accretion in 1 to 19 days.

In 73.2 and 72.6 percent of the cases the "apparent" dilution became accretion in 1 to 24 days.

In 78.5 and 76.7 percent of the cases the "apparent" dilution became accretion in 1 to 30 days.

In 90.4 and 91.5 percent of the cases the "apparent" dilution became accretion in 1 month to 3 months.

In only 9.6 and 8.5 percent of the cases did the "apparent" dilution fail to become accretion in 3 months or less.

In 69.2 percent of the cases when there could have been "apparent" dilution and 60.1 percent of the cases when "apparent" dilution existed by reason of sales the dilution was 1 percent of less per share sold.

In 92 and 86.5 percent of the cases the "apparent" dilution was 2 percent or less per share sold.

In 97.5 and 95.5 percent of the cases the "apparent" dilution was 3 percent or less per share sold.

In 99.2 and 98.2 percent of the cases the "apparent" dilution was 4 percent or less per share sold.

In only 0.8 and 1.8 percent of the cases was the "apparent" dilution over 4 percent per share sold.

Note that such "apparent" dilution would be a great deal less per share outstanding and would be substantial per share outstanding only when sales were very large in proportion to shares outstanding.

The aggregate "apparent" dilution on sales made by General Capital during the period amounted to about two-tenths of 1 percent per year on average assets at market.

The aggregate actual accretion based on the time the cash proceeds of sales were invested, estimated as carefully as possible, amounted to about three-tenths of 1 percent per year on average assets at market.

The foregoing statistics prove to our complete satisfaction that General Capital and its shareholders have not only suffered no material dilution but have actually realized a slight amount of accretion from the sale of its shares. They also indicate that the principal problem relates to the investment of the cash proceeds rather than to the sale of the shares and that this problem is not a difficult one since the opportunity for accretion in a short time, as shown by the statistics, is so great.

Restriction of sales when "apparent" dilution is large

The one restriction on pricing which we believe is advisable and which we believe the Securities and Exchange and Commission should impose under its authority under the Securities Act of 1933 relates to sales at times, which occur infrequently, when "apparent" dilution per share is large. We believe such a restriction should be developed by the Securities and Exchange and Commission, the National Association of Securities Commissioners (an active organization composed of the State securities commissioners), the National Association of Securities Dealers, and representatives of the industry working in cooperation. The associations mentioned have been working on this problem.

Based on our experience and our limited information concerning the industry as a whole we believe such a restriction should not limit sales where the "apparent" dilution is not over 3 percent per share sold and should not be so arbitrary as to interfere in any other way with effective sales promotion, which is in the interest of the present and prospective share holders despite the impression given that it is principally in the interest of managements and distributors.

OUTSIDE AFFILIATIONS OF DIRECTORS AND OFFICERS

We believe the bill's restrictions on outside affiliations of directors and officers would unnecessarily restrict the right of stockholders to elect whomever they wish to manage their investments. We believe the bill would unnecessarily prevent such reasonable concentration of management as is necessary to insure good teamwork and to prevent inefficiency resulting from unnecessary conflicts within the management. In the case of General Capital the bill would compel either the abolishment of the management company (Capital Managers), or the election of a number of unaffiliated directors. We believe this would not be in the best interest of stockholders and we believe a large majority (if not all) of the stockholders would share this view.

We believe the bill's restrictions in this matter would in most cases result at best in the election of some directors who would be more or less subservient to others, in whom the effective control of the management would lie, or at worst in inefficiency resulting from conflicts among the directors. We believe the bill would effectively deny to stockholders the opportunity to have the services of many of the best men for the job, because of restrictions on affiliations which actually would not, in most cases, conflict with the stockholders' best interests.

Insofar as open-end management diversified investment trusts at least are concerned we believe present Federal and State regulation applicable to this subject is adequate and that further Federal regulation is unnecessary and undesirable. We doubt if further Federal regulation of this kind is necessary or desirable for trusts of other types.

If further protection of stockholders against misconduct of directors and officers is necessary and desirable we believe it should take the form of reasonable requirements for full publicity, and reasonable restrictions against certain kinds of action without full publicity and without stockholders' approval rather than the bill's form of drastic prohibition of outside affiliations and drastic restrictions on activities.

BOSTON METAL INVESTORS, INC.,
Boston, February 3, 1940.

MEMORANDUM ON PROPOSAL THAT AFTER 1 YEAR THERE SHALL BE NO INTERLOCKING OFFICERS AND DIRECTORS BETWEEN DIFFERENT INVESTMENT COMPANY SYSTEMS

It appears to us that any rule which would prohibit an officer or director of one investment company from being an officer or director of another, would be most unfair to the smaller investment companies and would prevent them from obtaining the highest type of management.

When this company was being formed in the early part of 1939, the organizers sought out men of the highest standing and greatest investment ability and experience to be its directors. The number of such men is obviously limited in any community, and it was only natural that the services of the best men had already been obtained by older companies.

In the event that a rule should be enacted preventing them from being directors of more than one company, it is obvious that our company would lose their services as the older and larger companies would be able to pay them more. We should, therefore, lose the services of the best men on our Board, and be greatly handicapped thereby. We feel that this would be a most unfair discrimination in favor of the large investment companies against the small ones.

BOSTON METAL INVESTORS, INC.,
By MALCOLM W. GREENOUGH, *President.*

BAY STATE FUND, INC.,
Boston, Mass., April 16, 1940.

Hon. Senator ROBERT F. WAGNER,
Chairman, Subcommittee, Senate Committee on Banking and Currency,
Washington, D. C.

DEAR SIR: We have examined the bill S. 3580, providing for the registration and regulation of investment companies and investment advisors to determine what effect its provisions might have on the stockholders' present and future investment in this trust; and on the officers' and directors' administration and management of the fund. The officers of this fund have, furthermore, discussed this bill with a number of the stockholders and, expressing the attitude of both the management and the stockholders toward this proposed legislation, ask that these objections be filed as part of the record.

We would welcome reasonable regulation as long as it is clear and understandable. It is our opinion that reasonable regulation springs from complete disclosure. Complete disclosure, however, is already required under the Securities Act.

We are absolutely opposed to this bill in anything like its present form and believe that the record of this open-end trust and others with which we are acquainted most certainly does not warrant the spirit of vindictiveness against the whole investment trust group that apparently motivates the authors and proponents of bill S. 3580.

We do not propose in this memorandum to discuss the bill in detail or show the effect of each of its sections on the operations of this investment fund. We do wish to cite particularly several provisions which we believe are entirely unreasonable and in going far beyond wise regulation would have the effect of denying to the stockholders the management that they had selected to supervise and administer their property and would quite probably necessitate the liquidation of this fund. In this connection we would point out that over 95 percent of our stockholders are personally known to at least one of the directors of the fund. They own shares in this fund because they believe in its management.

We believe unnecessary and unsound the delegation to the Securities and Exchange Commission of the power to make general rules and regulations and specific orders concerning many aspects of our operations that are solely a proper function of the management.

We are at a loss to discover the abuses by the open-end trusts that this bill seeks to correct. Maybe turn-over is supposed to be an abuse. It happens that this fund has not had a large turn-over of portfolio, but it strongly opposes any limitation on what its turn-over can be. Only the necessities of future circumstances can properly decide that. However, it may be reasonable that a trust

be required to state what its turn-over has been and compare it with what the Securities Exchange Commission may state to be its idea of a proper turn-over. Then if stockholders think the turn-over excessive, they may exercise their right to retire. Such a technique would obviate the need for rigid requirements.

We are absolutely opposed to restrictions placed on the investment policy of the management. Under rapidly changing conditions, it is neither desirable nor practicable to hold special stockholders' meetings to approve a change in investment emphasis. The stockholders have selected the management, and delegated to them the right to act in the way best calculated to accomplish the desired objectives. The stockholders do not wish to substitute the judgment of the Commission or any other group for the judgment of the management, nor can the management operate an investment fund effectively unless they are allowed complete investment freedom within such limits as are imposed by its articles of incorporation. Arbitrary and unnecessarily rigid requirements and red tape will surely impair successful operation.

The proposal (sec. 10) that certain people, because of their relationship with a company or because of their characterization as broker, and so forth, shall constitute only a minority of the directors would force resignation of directors and officers and disrupt a board selected by the stockholders as the group to which they wanted to entrust their funds. This provision would result in staffing a company with personnel that would be certain, almost by definition, to have no specialized knowledge of the field of investment. We can see no useful purpose accomplished by this section of the bill and can see a great deal of harm and confusion, with loss to the stockholders. A prerequisite to successful management is coordinated, cohesive thought, and action along the lines of a common policy.

The provision prohibiting as director a person who acts as broker for the company would cause the removal of a trained person who can be, and in our case has been, of considerable aid. Here again, complete disclosure, as in the case of turn-over, would require that all facts be given the stockholders and leave it to them to see whether or not the connection brought abuse or benefit.

This particular fund is small. On December 31, 1939, the total value was $147,000. There were 103 stockholders. The necessary expenses of auditors, custodian, and transfer agent, already impose a heavy burden against income. To comply with the provisions of the bill under section 30 requiring the filing of such reports, information, and documents as the Commission may deem appropriate and the possible demands for information of all types would penalize severely the stockholders and cause their income to be diverted to the preparation of this information for the Securities and Exchange Commission. We send to all stockholders quarterly reports, fully disclosing all pertinent information. The probability of filing numerous and an unknown number of reports with the Securities and Exchange Commission places a large contingent liability against the stockholders and must result in the diversion of the management's attention from the primary job of management itself.

We also believe that the problems of regulation of open-end investment trusts are so different from other investment companies, that they should be treated in separate bills.

Respectfully submitted.

Bay State Fund, Inc.
By Donald B. Litchard, *President.*

A Brief Prepared Relative to S. 3580—Section Covering Investment Counsel—In Opposition

I am Donald Holbrook, with offices at 111 Devonshire Street, Boston, Mass. I am, and have been for many years, a private trustee managing estates and private trusts under the traditional Massachusetts trustee practice. I am not an attorney.

I own the majority of stock in a small corporation known as the Holbrook Co., Inc., which acts primarily as a service organization to assist me in the management of private trusts and estates. In addition to this work, this corporation acts as investment counsel to a limited clientele, who, for one reason or another do not wish the formality of trust procedure. I regard the investment counsel activities of this corporation as being on a strictly professional basis. It receives no additional compensation from brokers or from the sale or purchase of securities, and its remuneration is limited to a professional fee for services rendered.

The corporation does not solicit business in a commercial sense, and operates under the same ethical standards which are considered customary with doctors and lawyers.

The corporation has some clients outside the State of Massachusetts who have retained its services without sales solicitation. Routine correspondence with these clients would seem to bring the corporation within the meaning of the act under the heading "Interstate Business."

The writer welcomes regulation which will provide proper publicity and distinction between those who render true investment counsel on a professional basis and those who may be said to offer wholesale statistical and investment recommendations or who advise on investments for other than a professional fee. The writer, however, believes that it is not to the best interests of investment-counsel clients, now or prospective, to so restrict or supervise the activities of true investment counsel as to jeopardize seriously the investment management and operation of small counsel firms. Nor does it appear that there is any reason for a form of supervision which would mean filing of letters, documents, reports, etc., which, by the very nature of the profession, should remain confidential.

Size of firm or number of employees is not a criterion as to the competence of any investment-counsel concern. The number of accounts and the size of each account has a direct bearing on the relative facility with which a small counsel concern can handle business against a large one. It is a fact that a $1,000,000-account can be more easily handled than 10 $100,000-accounts.

The writer believes that if lawyers are exempt from the provisions of this bill a private trustee whose occupations are private-trust management, investment counsel and research should also be exempt. I know of no peculiar qualification which an individual has by the simple fact of being an attorney which makes him more competent to advise on investments than one who has made a life study and practice in this profession.

Because of the personal and confidential nature of the work, small investment-counsel concerns, even limited to one member operating under the right circumstances, have an equal and even greater opportunity of rendering sound investment counsel than a large firm handling many millions and a large number of accounts.

The writer, on account of the foregoing, believes that the present section covering investment counsel in Senate bill 3580 is not to the best interests of investors who turn to true investment counsel for unbiased and competent advice and that an unnecessary hardship on small investment-counsel firms would result from its enactment.

DONALD HOLBROOK.

MEMORANDUM TO THE COMMITTEE ON BANKING AND CURRENCY RELATIVE TO S. 3580

The subscriber hereto is a trustee of General Investors Trust, a small trust organized under the laws of Massachusetts, (ch. 182, Revised Laws, Ter. Ed.). The trust is managed by three trustees. It is an open-ended investment trust with a portfolio which is designed to give security and substantial income and not as a common stock fund with speculative attractions. It paid to its share holders dividends of 4¾ percent during 1939 and we expect to pay 5 percent or more during the current year.

Shares are redeemable at full liquidating value immediately upon offer. Funds are in the hands of a custodian, the Boston Safe Deposit & Trust Co. under an irrevocable contract which makes it impossible for the trustees ever to handle the securities of the trust. There is no dilution permitting purchasers to buy at a lower value than the actual liquidating value. Shares are not sold during the time when the stock exchange is open and orders are taken at the closing prices of the stock exchange which fixes the price of the shares until the stock exchange reopens. The trustees receive together 6 percent of the gross income not including capital gains, and receive no other compensation or profit of any sort from the trust fund or from the distribution of its shares.

Massachusetts trusts with transferable shares of beneficial interest have been used in Massachusetts for many years and their functions, limitations and obligations have been the subject of many judicial decisions in Massachusetts. In order to prevent partnerships from limiting their liabilities by taking on the form of a trust, it is settled law in Massachusetts that if the holders of so-called cer-

tificates of beneficial interest have the ultimate contol of the trust, they are partners and are jointly and severally liable. The shareholders, therefore, do not elect trustees and if the provisions of S. 3580 requiring annual elections are enacted, it will result, under Massachusetts law, in the imposition of a joint and several liability upon each shareholder.

This question was considered 12 years ago by the Massachusetts Legislature and I am annexing hereto a copy of a report to the Massachusetts Senate upon the question.

It is submitted that shareholders have a greater protection under a Massachusetts trust than under any other form of organization. The obligation of a trustee to his beneficiaries is more strict and definite than the obligation of a director of a corporation. He cannot deal to his own advantage with the property of the trust. For example, if a trustee takes advantage of a price change to purchase shares of the trust at a figure below the liquidating value and to sell at a higher figure, as testimony before you indicates was done in September 1939, a trustee would be personally liable and the liability could be immediately enforced by a petition to the probate court with the probability that the proof of such dealing would result, not only in an order to make restitution, but in the removal of the trustee.

The beneficiary's rights under a Massachusetts trust would seem to be greater than those of stockholders of a corporation and more quickly enforceable. The corpus of the trust is much safer from the manipulations of the management than is a corporation and the protection of the shareholders against mismanagement and incompetence is in the hands of a disinterested court and available instantly, not at an annual meeting which may be months away.

We trust that you will take this form of organization into your consideration. We believe that trusts such as the one we represent have a real place in the economic structure. They give the small investor much more income than he can receive from a savings bank and by the diversification of their portfolios, give him greater security than an investment in a single stock would give.

We are not opposing proper regulation. We ourselves have cooperated with the securities divisions of various States and have taken the lead in prevention of dilution by the double-price method of selling shares. We are still to learn of any Massachusetts trust which has been charged with the abuses which S. 3580 seeks to correct, and we hope that in whatever form legislation is enacted, such legislation will not prevent the existence of the so-called Massachusetts trust.

Respectfully submitted,

John H. Sherburne,
Chairman, Board of Trustees, General Investors Trust.

[S. No. 2, the Commonwealth of Massachusetts]

Report of the Board of Bank Incorporation and the Department of Public Utilities, Acting Jointly, Relative to the Regulation and Control of Investment Trusts and to the Enforcement of the Sale of Securities Act, So-Called.

[Banks and banking]

Department of Public Utilities,
December 5, 1928.

To the Honorable Senate and House of Representatives:

Chapter 29 of the Resolves of 1928, reads as follows:

"RESOLVE PROVIDING FOR AN INVESTIGATION BY THE BOARD OF BANK INCORPORATION AND DEPARTMENT OF PUBLIC UTILITIES, ACTING JOINTLY, RELATIVE TO THE REGULATION AND CONTROL OF INVESTMENT TRUSTS AND TO THE ENFORCEMENT OF THE SALE OF SECURITIES ACT, SO-CALLED.

"*Resolved,* That the board of bank incorporation and department of public utilities, acting jointly, are hereby authorized and directed to investigate the subject matter of so much of the address of his excellency the governor, printed as current senate document number one, as relates to enacting additional legislation so as to prevent credulous investors from being defrauded by unscrupulous promoters and operators, and of current senate documents numbers one hundred and seventy-seven and one hundred and seventy-eight, and current house document number four hundred and sixty-one, relative to the regulation and control

of investment trusts and to the better enforcement of the sale of securities act, so-called. The joint board shall report to the general court its findings and recommendations, if any, and drafts of such legislation as may be necessary to carry the same into effect, by filing the same with the clerk of the senate, not later than December first in the current year.

Pursuant to the resolve, as quoted above, the Board of Bank Incorporation and the Department of Public Utilities, acting jointly, has held an advertised public hearing, attended by numerous persons who were given an opportunity to set forth their opinions and suggestions in full, has made an investigation, and has held several conferences at which various persons from New York and Massachusetts, interested and experienced in the business of conducting investment trusts, have appeared and stated their views.

At the present time one hundred and one investment trusts or corporations, whose business is that of investing in the securities of other corporations or trusts, have qualified their securities for sale in Massachusetts under the provisions of the so-called Sale of Securities Act. The Department of Public Utilities is requiring at the present time from each of said investment trusts or corporations engaged in investment trust business frequent reports setting forth in full its financial position, including an income account and balance sheet, a list of the securities owned or held, and the prices paid therefor and the market value thereof. The said trusts or corporations are also required to set forth in full that part of their income derived from dividends and interest received, and, further, to set forth that part of their income derived from increase or increases received from any resale or resales of their securities. This information, including balance sheets, income statements, personnel of management and regulations under which business is conducted, is open to public inspection, and therefore available to the prospective investor.

Comparisons, mistaken, we believe, have been made between investment trusts and banks in their relations to the public. Investment trusts have no depositors and thus have no cash demand liabilities such as banks have. They perform none of the functions of a bank. Investment trusts and corporations as a usual rule have no liabilities other than their liability to stockholders or beneficiaries of the same character that ordinarily pertains to any corporation or trust.

There seems to be a popular impression that a beneficiary in an investment trust is not in as good a position to protect his interest as a stockholder in a corporation engaged in a like business. This, we think, is not so as to trusts over which the courts of this Commonwealth have jurisdiction. In fact, a beneficiary is in a much more favorable position to protect his interest and to see to it that the trust is conducted in an honest and efficient manner than is a stockholder in a corporation.

Section 12 of chapter 203 of the General Laws provides that—

"The supreme judicial court, the superior court or the probate court may, upon petition of a party beneficially interested in a trust under a written instrument, and after notice to the trustee and all persons interested, remove the trustee if it finds that such removal is for the interests of the beneficiaries of the trust or if he has become insane or otherwise incapable or is unsuitable therefor."

Under this statute it seems to us that the court has broad and sweeping powers, on the petition of any beneficiary of such an investment trust, to remove the trustee or trustees if, in the opinion of the court, such removal is for the benefit of the beneficiaries. The court has no such power in the case of directors of a corporation. Thus, in our opinion, the beneficiaries of an investment trust have greater protection than the stockholders of a corporation.

Strenuous objections were made by representatives of some investment trusts and corporations doing a like business to any system of regulation which would make public their investments. It was urged that the investment trusts, in which the speakers were interested, made careful and exhaustive investigations of the business of the corporations in whose securities they invested, very often entailing months of study and the expenditure of large sums of money. They contended that it would be unfair, after the trusts had made these examinations and made investments on the strength of the information obtained, that others should be able to take advantage of their examinations and expenditures, at no expense to themselves, in investing in like securities. It was also suggested that by making public their investments it would create a competition for the securities as to which they had made an investigation which would necessarily either enhance the price or exhaust the supply of the securities. Be that as it may, in our judgment there is no practical way of regulating investment trusts except by some sort of supervision of the nature that applies to banks, or by such regulation as now applies under the Sale of Securities Act, together with publicity.

We think it inadvisable to deal with investment trusts in the same way that we deal with banks. As we have pointed out, investment trusts are in their nature no different from corporations engaged in a like business, and do not vary much, so far as the beneficiary is concerned, from any other form of collective enterprise whose purpose is the making of a profit. There seems to be no sound reason why supervision of the character applying to savings banks should be exercised over their investments or their business in the interests of the shareholders that does not pertain to any other private trust or corporation. If we once engage in such supervision of the investments of investment trusts, there seems to be no logical reason why it should not be extended to a wide field of private undertakings. To do this would bring an enormous expense upon the Commonwealth if the investments are to be supervised with any degree of effectiveness. At the same time, the mere fact that the State undertook so to supervise these investments would lead the public to place undue reliance upon such supervision, rather than to take means to inform themselves. No instance has been brought to our attention where any State has undertaken such supervision. No information has been presented to us which would warrant us, at this time, recommending any such policy upon the part of the State.

We believe that a system of filing returns with the State and making those returns private places too great a responsibility upon a regulating body, unless that body is given funds and power substantially the same as the Commissioner of Banks possesses in relation to savings banks. As a consequence, we think that if any attempt is to be made to assure the holders of investment trust certificates that the trusts are being conducted in a sound and honest manner, there should be available to the holders of trust certificates, at reasonable times, full information in relation to the character of the securities held by the investment trust. We know of no way in which this can be done except that periodically investment trusts be required to file, in addition to other information, statements of their investments which will be open to the public, and we feel that this is the system which should be adopted by the State, at least for the present. It follows that such provisions should apply to persons and corporations engaged in like business.

At the present time investment trusts, and persons and corporations doing a like business, are subject to the Sale of Securities Act, and consequently, to the extent defined in the act, come under the jurisdiction of the Department of Public Utilities. The Department has for some time in the past required statements from time to time from these trusts, persons and corporations, which information is open to such members of the public as desire to examine the returns.

Question has been raised as to whether, under the provisions of the Sale of Securities Act, the Department has the authority to require the filing of returns in the manner in which it has heretofore been done. We suggest that the Sale of Securities Act be amended so as to remove any question as to the power of the Department exercising this authority, and submit a bill to that effect, marked "A."

The resolve directs us to investigate the subject matter of Senate Documents Nos. 177 and 178. Senate No. 177 provides for the regulation of investment trusts under the supervision of the Department of Public Utilities, and Senate No. 178 provides for the regulation and control of investment trusts under the supervision of the Commissioner of Banks. The cardinal feature of both bills is that such investment trusts shall not invest in securities other than those approved, on the one hand, by the Department of Public Utilities, or, on the other, by the Commissioner of Banks. As we have already stated, we think it inadvisable to deal with the investment trusts on the analogy of banks or banking institutions. It follows that we do not recommend the adoption of the provisions of either bill.

The resolve also directs us to investigate the subject-matter of so much of the address of His Excellency the Governor, printed as Senate Document No. 1, as relates to enacting additional legislation so as to prevent credulous investors from being defrauded by unscrupulous promoters and operators. In the consideration of the whole subject-matter of the resolve we have given careful consideration to the suggestions contained in the address of His Excellency the Governor. We assume that that portion of the message of His Excellency that recommends that the duty of enforcing the statute regulating the sale of securities be transferred from the Department of Public Utilities to the Department of the Attorney General is not referred to us under this resolve. As a consequence we make no report thereon.

We are also directed by the resolve to investigate the subject-matter of House Document No. 461, relative to the better enforcement of the Sale of Securities

Act, so-called. This bill provides for the creation of a division, to be known as the Securities Division, in the Department of Public Utilities, and the appointment of a Director to have general charge of the Division, with an appeal to the Commission from the decision of the Director. This bill, we think, has merit in that it would relieve the Commission of dealing with a large amount of detail work which in its nature is foreign to the activities for which the Department was originally created, and would tend to relieve the Commission which is now overburdened with work. Moreover, the appointment of an official whose sole duty was the supervision of the enforcement of the act might tend to better efficiency. The general scope of the bill meets with our approval. We think, however, that there should be some minor amendments to the bill, and as a consequence we submit the bill in a new draft, marked "B," with the recommendation that it be adopted by the General Court.

Respectfully submitted,

BOARD OF BANK INCORPORATION,
ROY A. HOVEY,
Commissioner of Banks.
HENRY F. LONG,
Commissioner of Corporations and Taxation.
WM. S. YOUNGMAN,[1]
Treasurer and Receiver General.
DEPARTMENT OF PUBLIC UTILITIES,
HENRY C. ATTWILL,
EVERETT E. STONE,
HENRY G. WELLS,
LEONARD F. HARDY,
LEWIS GOLDBERG,
Commissioners.

"A"

[The Commonwealth of Massachusetts. In the Year One Thousand Nine Hundred and Twenty-Nine. An Act for the Better Enforcement of the Sale of Securities Act]

Be it enacted by the Senate and House of Representatives in General Court assembled, and by the authority of the same, as follows:

Chapter one hundred and ten A of the General Laws is hereby amended by inserting after section six thereof the following new section:

Section 6A. The commission may also require any person whose securities may be sold to file periodic statements, under oath and sworn to by a reputable public accountant, showing the financial condition of such person and such further information as the commission may deem advisable, in such form as it may from time to time prescribe. Failure to submit the information so required within the time specified shall be deemed by the commission just cause for the making of a finding to the effect that the sale of such securities is fraudulent or would result in fraud.

"B"

[The Commonwealth of Massachusetts. In the Year One Thousand Nine Hundred and Twenty-Nine An Act for the Better Enforcement of the Sale of Securities Act]

Be it enacted by the Senate and House of Representatives in General Court assembled, and by the authority of the same, as follows:

Chapter one hundred and ten A of the General Laws is hereby amended by inserting after section twelve thereof the following new section, to wit:

Section 13. There is hereby established within the commission and under its general supervision a division to be known as the securities division. The commission may, with the approval of the governor and council, appoint a director of the securities division who shall not be subject to the provision of chapter thirty-one of the General Laws. Said director shall hold office for the term of five years unless removed for cause by the commission, with the approval of the governor and council, or by the governor. It shall be the duty of said director to administer and enforce the provisions of this chapter, and for this purpose he shall have and exercise all the authority conferred by law upon the commission, including the authority conferred by chapter two hundred and fifty-nine of the acts of the year nineteen hundred and twenty-two, but subject to the supervision and control of the commission in such manner as the commission may determine. Said director

[1] With dissent on term of five years for Director of Securities in bill marked "B."

shall receive such compensation as may be fixed by the commission with the approval of the governor and council. During the absence or disability of said director, his duties may be performed by the commission. The commission may likewise appoint and provide such employees as may, from time to time, be necessary to the proper administration of this chapter. Any interested person aggrieved at any official act of the director of the securities division shall be entitled to a hearing as provided in section seven hereof.

Senator WAGNER. We will next hear from Mr. Richard Wagner.

STATEMENT OF RICHARD WAGNER, PRESIDENT, THE CHICAGO CORPORATION, CHICAGO, ILL.

Mr. WAGNER. Mr. Chairman and Senators, I am president of The Chicago Corporation, a closed-end management type company conforming to the characteristics which the Commission has termed a "securities finance company." The net assets of The Chicago Corporation at this time are approximately $32,000,000. I have never been connected with an investment banking concern. I have had no part in the actual forming of the corporation or of those two companies which were later merged with it. My training was in commercial banking, from 1910 until late 1930, when I became an officer of the corporation, about a year and a half after its formation. In 1938 I was elected president. I would like to tell you a little about our activities because I think they have a bearing on the bill under consideration here.

At the time of the formation of the company the following description of its business appeared in the offering prospectus, a photostatic copy of which I would like to hand you, which contains some rather interesting phraseology [reading]:

> The Chicago Corporation has been organized under the laws of Delaware to buy, sell, and trade in stocks and securities of any kind, to participate in underwritings and syndicates, and to engage in such other investment activity as its board of directors may determine. The Chicago Corporation is not a so-called "investment trust", but is a financial corporation designed to supplement the existing facilities of the Middle West.

That is rather a broad statement. [Continuing reading:]

> There are no restrictions on the investment authority of the directorate within the broad provisions of the certificates of incorporation.

You will observe the specific statement that the company is not an investment trust. You will note likewise that no one could possibly confuse the securities offered with a plan for savings. Frankly, we feel that the emphasis in these hearings, that these investment companies partake of the nature of savings banks, is particularly unfortunate as that emphasis might apply to closed and management companies. To what extent the offering prospectuses of other management companies contained similar statements, I cannot say definitely, but such as I recall were not greatly different.

As to whether people who bought these securities fully understood the purposes of these companies, I have only to recall to you the hectic conditions which prevailed at that time; that is, in the late twenties.

I have a very vivid recollection, and I am sure that you have, of the speculative fever which existed in the late twenties. Every issue was "snapped up" as soon as it was offered. To save money? Certainly not. It was the desire to make a quick profit. Few persons

escaped the contagion. Large pools of capital were hastily thrown together, and it was under these conditions that many management companies were born. But to maintain that they were generally represented as plans for savings is not in accordance with the facts.

As an illustration, one of these companies which was later merged with our company, started out with $60,000,000. Within a day after the announcement of its formation there was over a billion dollars of subscriptions entered for the stock by people who wanted to buy it.

It may be inappropriate to compare the experience of those who purchased securities of investment companies in the late twenties with the experience of savings depositors, though some of the latter lost money, too. But to supplement what Mr. Bunker has told you happened to the value of securities of management investment companies issued in 1929 compared with other securities issued and listed at that time on the New York Stock Exchange, which were issued during that period, it would, I think, be fair also to compare the experience of the public stockholders in investment companies with the results they would have had through purchasing bank stocks in that same period.

It is an interesting fact that the persons who bought the original public offering of the securities of the company I represent and retained them have fared better by a good deal than they would had they purchased any of the publicly traded bank stocks at the same time. This, according to Mr. Bunker's study, I believe would be true of most of the management companies which have survived.

To illustrate this point, the public offering of the original Chicago Corporation was of units consisting of one share of preferred and one share of common stock at a price of $66 per unit. The original offering of Continental Chicago Corporation which was later merged with the Chicago Corporation was an offering of units of one preferred and one common share at $68.50 per unit, and the third company which was merged with the Chicago Corporation, known as Chicago Investtors, was of a preferred stock only at a price of $50 per share. Apart from these public offerings additional funds were provided through common-stock subscriptions by persons or institutions closely identified with the directors and management. For instance, the Continental Chicago Corporation was organized by the securities affiliate of the Continental Illinois Bank of Chicago. That company purchased $15,000,000 of common stock in the Continental Chicago Corporation which was later distributed to the stockholders of the bank when securities affiliates of banks were liquidated under the 1933 Bank Act.

Total asset coverage for preferred stock of The Chicago Corporation at the outset in 1929 amounted to approximately $79 per share for each preferred share issued. Of course this asset value dropped greatly in the early thirties but by the end of 1936 there was again coverage for each preferred share of approximately $79.25.

These preferred stocks were entitled to $3 cumulative dividends and by the end of 1936 approximately $22 per share had been paid in dividends. During that year we find that one share of preferred in 1936 and one share of common combined sold for as high as $60.50, which was a close approximation of the original offering price. Today the market equivalence of the original units sold in 1929 is approximately $38.50 per unit, which is approximately 60 percent of the original offering price. So, taking the original offering price of the

units, it will be observed that the market today represents approximately 60 percent in the case of The Chicago Corporation of the original offering price, approximately 56 percent in the case of the Continental Chicago Corporation, and approximately 74 percent in the case of Chicago Investors Preferred.

Comparing this with what happened to stocks of leading Chicago banks we find that the present market price is from 19 to 26 percent of the prices attained in September 1929, and if we look at some of the New York banks we find that the percentage is somewhat less.

This statement is in nowise intended as a reflection upon these banks. This, I think, is indicated by the fact that we have very substantial holdings of bank stocks at this time.

It is interesting also to note that had the same money been invested in real estate mortgage bonds in the late 1920's, the investor would have fared even worse than had he purchased bank stocks, and in real estate mortgage bonds he thought he was not speculating. He thought he was buying a sound investment for an interest return only. A compilation which I have here shows that a large number of publicly quoted real estate mortgage securities issued in 1928 and 1929, and even in 1930, are today selling at from 5 percent to 25 percent of their original cost to the investor. Considering these facts I think it is only fair to recognize that purchases of stocks at offering prices in investment companies of the general management type have not caused investors losses comparable with those suffered in securities presumed to be of much less speculative nature, in all instances, certainly; and please bear in mind, gentlemen, that the market quotations for most management type company stocks are at a considerable discount from their true asset values today.

May I now refer again to the description of the business of the company which I read to you. In the hearings on April 9 Mr. Schenker referred to our company in the following terms [reading]:

> Recently the Chicago corporation has started to change the fundamental nature of its business and is attempting to serve a very useful function—

Thank you, Mr. Schenker—

> in making capital available to small industries. But in those circumstances, because the securities they get are not liquid and have no market, they necessarily have to take a controlling position to protect their investment.

Then, Mr. Chairman, you stated [reading]:

> I do not see any objection to that method of changing their activities; but should not the stockholders know about that, who originally put their money in under certain definite assurances?

The point I wish to make is that we have not changed our fundamental policy. I again refer you to the original offering prospectus.

We told them in the beginning what we were going to do, what we were trying to do, and what we had actually accomplished. I want to make the point clear that we did not change our fundamental policy by that proceeding. I think Mr. Schenker will agree with that.

We have endeavored to find employment for a portion of our funds in what we call "intermediate financing," for want of a better term. By this I mean such activities as the seasoning of securities prior to public offering, extension of working capital to companies unable to obtain it from regular banking channels, supplying senior capital for new enterprises and for reorganizations, participating in under-

writings, and in occasional instances arranging orderly liquidations.

I think you will agree with me that such activities perform a useful economic function, but there seems to be a general impression that they constitute an extremely hazardous business. Our experience does not justify that assumption.

At this time approximately 30 percent of our total funds is employed in investments of this character.

When I use 30 percent—because Mr. Schenker might question that a little later—I want to include there some of those investments that have since become market securities. Of course we undertake them for profit, but we believe they do contribute to the general economic good.

For example, at the depth of the depression when there was over $1,000,000,000 in real-estate bonds in default in the city of Chicago alone and no vehicle to finance reorganizations, we participated in the formation of a real-estate mortgage company, known as the Fort Dearborn Mortgage Co., to make reorganization loans and discount the paper with the R. F. C. We acquired full control of that company in 1933.

In his statement to the House Committee on Banking and Currency in asking for extention of the R. F. C. powers in 1935 Mr. Justice Reed, who was then counsel for the R. F. C. stated [reading]:

> I think that the Fort Dearborn Mortgage Co. has done a great deal of good. I know of no reason why I should not say, so far as I know, the Fort Dearborn Mortgage Co. has done a more useful piece of work than almost any other mortgage company I know of and, so far as I know, they have handled it in a very economic and satisfactory manner.

The total amount of loans made through the Fort Dearborn Mortgage Co. was $9,779,000 against total original bonds issued for the properties involved of over $100,000,000. The activities of the Fort Dearborn Mortgage Co. encouraged the return of institutional lenders to the Chicago real-estate mortgage field, and by late 1935 it again became possible to obtain real-estate loans at reasonable rates from them. The R. F. C. was fully repaid and the company then turned to the real-estate field itself, purchasing and liquidating 300 small homes pledged under a bond issue and also to some extent engaging in the building and sale of residences.

In another instance Chicago Corporation supplied the capital necessary for the reorganization of a food company which was in receivership. Obviously we did so for the purpose of making a profit, but as a consequence of our action over 1,000 jobs were kept secure.

In another instance we supplied capital to a new company which constructed two plants for the extraction of distillate from natural gas which I am told provided over 400,000 man-hours of employment, and has resulted in a new technique in the production of a natural resource.

We underwrote a common stock offering to the stockholders of a moderate size steel company which could not sell its securities publicly. In another instance we supplied the major part of the capital to build and operate a sugar refinery. I could go on with a number of illustrations, but these should suffice to give you the nature of these activities. Our experience in them has been, on the average, highly satisfactory.

Obviously, we must use care in the selection of risks just as a bank does. The risks are in varying degrees greater than the extension of ordinary bank credit, but we do have a cushion which banks do not have. A bank makes an intermediate loan for interest return only. We require a participation in the equity of the business as additional compensation and we may require the right to control until a substantial portion of our advances have been repaid. Control for no other purpose than to protect our investment. We do not wish to manage anything we do not need to. Our original premise is that we will make no investment unless we are satisfied that sound management is present or is available to the enterprise under consideration. But of course we can be wrong about management and we want the right to change it if the enterprise we have invested in is not being operated properly. Our purpose is to dispose ultimately of successful undertakings. We feel that these activities make us merchants in capital and we are interested in the turn-over of our merchandise.

I have gone into some detail concerning our activities because I believe, as I have stated before, that they offer an opportunity for profit while performing an economic service and I would personally deplore any action here which would discourage the participation in that field by other investment companies. I think you will agree that in recent years concentration of capital in the hands of private individuals available for risk purposes has diminished, whether through the working of the tax laws or through the creation of trust accounts limited to fiduciary investments. While it may be true that not many investment companies have engaged in activities of the kind I have described, the fact is that more of them are becoming interested. We have occasionally invited other investment companies to join us in these undertakings and I am glad to say that they have in several instances.

As a matter of fact, a number of them have done quite a few of the same type of things that we have done.

I feel strongly that nothing should be done to handicap and restrict the flow of capital for these purposes. During the past several years we, ourselves, have expanded very slowly in this direction, partially because we did not have any clear idea about what kind of legislation the Securities Commission would propose to regulate investment companies.

There are instances in the bill before you which would, I think, restrict us and we are disturbed about the broad regulatory powers proposed for the Commission. We would like to know what the rules are going to be, because the type of investments we wish to undertake include those which require up to 5 years' time to mature.

For this reason, we believe that any Federal legislation should be simple and specific, and the broad discretion now proposed limited to reasonably necessary administrative discretion. I am mindful of Judge Healy's statement, and I have a very high respect for Judge Healy, that the broad powers proposed are desired in the interest of the investment companies themselves, but I am also mindful that the language employed leaves the character of the regulations and the effect of the act wholly uncertain at the outset—being wholly in the hands of the Securities and Exchange Commission.

I do not plan to discuss the various sections of the bill because that has been ably done by a number of witnesses who appeared before you. In general, I concur with Mr. Bunker and Mr. Quinn regarding specific sections, but I do wish to comment upon the departures in this bill from generally accepted ideas as to the sphere of Government regulation.

For example, is it not a new approach and does it not savor of ultimate Government control of business generally, when we begin prohibiting the borrowing of money by a business, when we seek to limit capital structures in the future to common stock, when we set minimum and maximum sizes which business may attain, and when we prohibit loans to natural persons who are in no wise connected with investment companies? Provisions denying redress to the courts without the permission of a bureau, to the denial of the right to purchase securities issued except by permission, to the registration requirements for individuals and to the already much-talked-of provisions of section 10 (e) applying to directors.

I just want to say this, that if this bill becomes law I would lose every director I have on our board, unless they were willing to give up substantial positions as directors in other companies or unless we were willing to sell a very substantial part of our general investments with respect to which we are best informed.

In our company, as a matter of policy, we have believed it unwise to borrow money, but we do not believe that it is a matter for law. We think that it is a matter of management policy and judgment, with respect to which stockholders should, of course, be informed.

On the question of borrowing money, I discussed this with Mr. Schenker and he told me very frankly that it was not intended to make that application to subsidiaries. On the other hand, I look at section 36, and from its language I wonder, because in the case of the Fort Dearborn Mortgage Co., we take into consideration doing a job with respect to unpaid taxes on properties in Chicago, and we have arranged a loan of $4,000,000. We have an investment in the company. If that does not apply to subsidiaries, we still have a prohibition against borrowing. Don't you see the loophole there? I do not believe it should be in the law.

Senator Downey. May I interrupt you just a moment?

Mr. Wagner. Yes, sir.

Senator Downey. Does it strike you, or does it not, that investment and borrowing are rather inconsistent?

Mr. Wagner. That depends upon the circumstances, Senator. We make an investment in the Fort Dearborn Mortgage Co., which has a specific business, that company being a real-estate mortgage company. I might say that at no time has our capital been in jeopardy. It operates against specific documents or instruments for a specific purpose, such as liberating, if you please, great amounts of bond issues that were present at that time. The collateral is specific. We do not borrow directly from The Chicago Corporation, but we may borrow through subsidiaries. It may be a sugar refinery.

In another instance, in the case of the little distillate company that I mentioned, we put up a certain amount of intermediate capital, and those companies can borrow from suppliers for the purpose of completing construction.

We may believe that ultimately the soundest structure of capital may be common stock for our particular business, but again we feel that this is not a matter for law but a matter for the stockholders.

In the course of the activities which I have outlined to you we may prefer to make a secured advance to a natural person to obtain an additional margin of safety, which you, Mr. Chairman, pointed out yourself in the testimony of a few days ago.

Concerning size, it is easy to agree that the maximum size proposed in the bill seems ample; but who knows? What would our economy be today if we had years ago set limits on the size business might attain? We are, furthermore, witnessing wide fluctuations in the values of world currencies. What will a specific dollar limitation mean a few years hence? I do not know, and I do not think anyone else does.

As to a provision for examinations by the S. E. C., that is, regular examinations such as the banks undergo, I see no need for it if regular audits by independent public accountants are required. The very nature of these companies require staffs that are relatively small in the interest of keeping expenses down to reasonable proportions. With regular auditors and revenue agents and the necessity of submitting voluminous data to the S. E. C. already required, we do need some time for the conduct of our regular business.

In conclusion, let me urge that the bill under consideration be modified so that it is specific, insofar as possible. The provisions outlined to you by Mr. Bunker seem to me to establish a good framework. If changes appear warranted after reasonable trial and experience, let such changes come through amendments carefully considered by this committee.

I sincerely hope that if, and when, a law is enacted, we can proceed with our plans for participating in constructive enterprises without undue restriction and without spending most of our time worrying about what the rules will be tomorrow.

We have at all times cooperated with the S. E. C. in its study and will be pleased to do so in any way possible in connection with this legislation.

That concludes what I have to say, Senator.

Senator WAGNER. Thank you very much, Mr. Wagner. Are there any questions?

Senator HERRING. No; I have none.

Senator WAGNER. Before we take a recess until 2:30 I would like to read, on this question of load, testimony by Mr. Schenker who referred to the loads charged. He referred to one company that received as high as a 20-percent load, and I asked him a question with reference to it, and he said [reading]:

> In other words, suppose the price of the certificate is $100 and they put a 20 percent load on it: That is $120 that you pay, but only $100 of your money is invested. Under those circumstances the management has got to make $20 on $100 before you are even.

That appears on page 290 of the printed testimony.

STATEMENT OF T. COLEMAN ANDREWS, MEMBER OF COMMITTEE OF THE AMERICAN INSTITUTE OF ACCOUNTANTS, RICHMOND, VA.

Mr. ANDREWS. Mr. Chairman and gentlemen of the committee, I am a member of the executive committee of the American Institute of Accountants. My home is Richmond, Va.

We have made a very careful study of at least one section of this bill, and we want to speak to you with respect to that one section; and in that connection I think it might be well to indicate to you in a sentence what we are not here for. We are not here to offer any objections to the bill as a bill. There is only one section that affects a matter upon which we feel we are qualified to speak, and that is the section to which I shall address myself.

In order to save the time of the committee we have prepared a brief statement, and I will present that rather than to go into it in any extended manner.

This statement, which deals only with section 32 (c) (1) of Senate bill 3580, has been prepared by a special committee of the American Institute of Accountants. The chairman of this special committee is the president of the institute, and its members include a vice president, two members of the executive committee, the chairman of the special committee on cooperation with Securities and Exchange Commission, and a member of the committee on auditing procedure.

The American Institute of Accountants is the national professional organization of certified public accountants in the United States, with a membership of 5,316, including the great majority of those who act as auditors for companies registered with the S. E. C. The institute's activities are similar to those of other professional organizations, including the maintenance and enforcement of rules of professional conduct, preparation of professional examinations, publication of technical and professional material, maintenance of an accounting library and a research department, and so forth. The institute has cooperated in various ways with many governmental and private bodies, including the Securities and Exchange Commission, which consulted the institute in the development of accounting rules and regulations under the Securities Act and the Securities Exchange Act. These matters are mentioned in order to inform the committee who we are, and to indicate that we are generally familiar with the type of problems with which Senate bill 3580 deals.

A good many sections of the bill relate to accounting and auditing. While we are, naturally, keenly interested in the bill as a whole, we believe it proper to restrict our recommendations to one provision of the bill, directly affecting professional certified public accountants as such, which we consider important enough to justify this appearance before your committee.

We earnestly recommend that section 32 (c) (1) of Senate bill 3580 be deleted. This section provides that [reading]—

> The Commission is authorized, by rules and regulations or order in the public interest or for the protection of investors—
>
> (1) to prescribe the minimum scope of and procedures to be followed in any audit of a registered investment company—

We object to this provision on the ground that it would permit assumption by a governmental administrative agency of a responsi-

bility which should be assumed by professional practitioners; i. e., determination of how extensive an investigation an independent auditor should make, and the manner in which he should make it, before signing his name to his own professional opinion regarding the financial position and the results of operations of the company under audit.

It is submitted that—

(1) Such a responsibility could not be successfully assumed by a governmental administrative agency;

(2) An attempt to fix minimum standards would tend to lower rather than to raise the standards of auditing practice;

(3) It would be a new departure in Federal legislation to provide for supervision by Government agents of the details of the work of professional practitioners;

(4) It would be an unwarranted and unnecessary invasion of a field of professional practice.

Senator Maloney. Do you feel that way about the reference you made in your statement to the development of accounting rules and regulations under the Securities Act and the Securities Exchange Act?

Mr. Andrews. I do not believe I understand your question, Senator.

Senator Maloney. Do you feel that there has been any abuse under those acts which you referred to earlier?

Mr. Andrews. Abuses against the profession of accounting?

Senator Maloney. Yes.

Mr. Andrews. No, sir. Our relations with the Commission up to this time have been, I should say, highly satisfactory. We have undertaken to work with them in a cooperative spirit; and that is one of the reasons why we think this particular provision is totally unnecessary, because we know that we can accomplish by cooperation far more than we can accomplish by legislation.

Senator Maloney. You refer to section 32 (c) (1) and say that you object to this provision on the ground that it would permit assumption by a governmental administrative agency of a responsibility which should be assumed by professional practitioners. Where is the guarantee there?

Mr. Andrews. The guaranty on the part of the accountant?

Senator Maloney. Yes.

Mr. Andrews. The exercise of professional judgment and the assumption of the responsibilities that go with it, Senator, are things that are inherent in the practices of any profession.

Senator Maloney. How about McKesson & Robbins?

Mr. Andrews. In the case of McKesson & Robbins or in any other cases you might mention, perhaps, there might have been some wrong doing. I believe that the determination of alleged malpractices there has not been finally disposed of; but I would like to say this, further, that the profession recognizes that in the assumption of a responsibility and in the conduct of its practice it is responsible to see that its practices follow proper rules of conduct, and that they are not negligent, and that they are skillful in the performance of their duties.

Senator Maloney. Do you think the auditors were negligent in that case?

Mr. Andrews. I do not think that is a proper question to ask me, Senator.

Senator Maloney. I will withdraw it. You prompted it, however.

Mr. ANDREWS. They may have been; but I will say this to you, that if the accountants were responsible in that case, we feel that the profession not only is capable of dealing with them as they should be dealt with, or from the standpoint of discipline, we can assure you that past experience will prove beyond any question that they will be dealt with properly. There has never been, as far as we know, any case of violation of a proper rule of ethics by any member of the profession that has not been dealt with conclusively. If there has been, we would like to know about it, because we have undertaken, to put it in the popular venacular, to police our own profession.

Senator WAGNER. Are there not statutes or public utility laws in some States as to accounting, or am I mistaken about that?

Mr. ANDREWS. It may be that there are statutes, Senator, which do prescribe minimum requirements, but I think their requirements are as to accounting rather than as to auditing. I should like to point out that there is a difference between the two subjects. When you audit something you verify it, check it, and give your opinion as to the correctness or incorrectness of it. You are then assuming considerable responsibility. We do not object to the portions of this bill which deal with accounting. We have no word to say about that.

Senator WAGNER. It is with reference to auditing that you object to it?

Mr. ANDREWS. Yes, sir; where we are called upon to give our professional opinion as to the truth and veracity of a statement, as to its full disclosure, there we think that you cannot substitute mandate or legislation for the exercise of professional judgment, any more than you can tell a doctor how to treat a pneumonia case, or a lawyer how to prepare his brief if he is going to represent you. After all, it comes back to the exercise of professional judgment.

It may clarify our suggestion to interpolate at this point a brief statement of the status of the certified public accountant and the nature of his work. There are, at present, more than 19,000 certified public accountants in the United States. The certificate of certified public accountant is issued by State administrative boards, created by law, to candidates who have met prescribed educational and experience requirements and have passed written examinations in auditing, commercial law, accounting theory and practice and, in some cases, other subjects. Certificates may be revoked for malpractice or unprofessional conduct.

The certified public accountant in professional public practice is an independent practitioner. He is not employed on a salary basis by the concerns which he audits but is retained by them as clients, on a fee basis. His position is different from that of the bookkeeper, internal auditor, or controller permanently employed by a corporation. The position of the independent certified public accountant is comparable with that of the practicing attorney, engineer, or physician performing services in particular cases for clients or patients who do not direct the professional man as to methods but look to him for results.

The rapid development of the profession of the certified public accountant is largely a result of the public demand for a disinterested, independent review and check by competent technicians of the accounting records and the accounting judgment of the management

of corporate enterprises which make use of the savings of the public. The certified public accountant recognizes a heavy responsibility to all interested parties, including stockholders, potential investors, and creditors, who may be influenced by his professional opinion regarding the financial position and the results of operations of the company concerned, as expressed in his report or certificate as a result of his audit.

An audit is not a simple mechanical process. It is a highly technical and complex procedure of examining or testing accounting records and the evidence which supports them. Some book entries may be confirmed by inspection of cash, securities, or other physical assets. Underlying evidence which may be called for to support other entries in the accounts may consist of such varying items as written confirmations of accounts with debtors or creditors, directors' minutes, contracts, vouchers, invoices, canceled checks, and so forth.

It is the duty of the auditor to satisfy himself that the accounts and the financial statements based on them fairly present the situation. He must use his own judgment as to the extent to which it is necessary to check individual records of transactions, and the manner in which they shall be checked, in order so to satisfy himself. Various factors—for example, the efficiency of the internal accounting or internal auditing of the company—may have a bearing on his judgment of the extent and nature of the examination which he must make in each individual case.

No two cases are exactly alike. Frequently the auditor finds it necessary to go further in some respects than is usual, and perhaps, in other respects, due to favorable factors, he may decide that it is unnecessary to do as much work as might be customary. He is responsible morally and legally for the opinion expressed in his report or certificate. He must decide for himself the amount and nature of the work he must do in order to justify the expression of his opinion.

If auditing were a simple mechanical process, the profession of the certified public accountant would not have developed so rapidly in numbers and in prestige. It is the need for skilled judgment, based on technical training and experience, which has brought into existence the thousands of certified public accountants who are practising in this country today.

The minimum scope of and procedures to be followed in an audit cannot satisfactorily be laid down by rules and regulations as is provided in section 32 (c) (1) of the bill. The auditor must use his judgment and discretion in determining the scope of the audit and the methods of procedure just as much as in formulating his final opinion on the balance sheet and income statement which are the subject of his report.

No Government agency nor any other body could set up practicable rules or regulations prescribing the scope (extent) of audit and the procedure (how to do it) to be followed by auditors in all cases. If that were possible auditing would be a routine procedure which could be left to clerks. No one can foresee the circumstances which the auditor will encounter in an individual case. The American Institute of Accountants has had considerable experience with this problem. It published in 1917, at the request of the Federal Trade Commission, an outline of points to be covered in typical examinations, under the title, "Approved Methods for the Preparation of Balance-Sheet

Statements," which was later approved by the Federal Reserve Board. This outline was revised in 1929, under the title "Verification of Financial Statements" and again in 1936, under the title "Examination of Financial Statements by Independent Public Accountants." The several revisions indicate growth and progress, as well as the impossibility of rigid standardization. It has been necessary in each bulletin to make clear that in individual cases an auditor may be justified in departing and may find it necessary to depart from these outlines, and may frequently find it necessary to go further than the outline suggests.

It has been frequently announced that the policy of the Congress in enacting the Securities Act was only to provide for full disclosure of material facts in the affairs of a company offering its securities for sale, in order that the prospective investor might have a fair basis for a decision as to whether or not to purchase the securities. The Securities and Exchange Commission requires that every prospectus issued under the 1933 Act bear the words, "These Securities have not been approved or disapproved by the Securities and Exchange Commission" and "it is a criminal offense to represent that the Commission has approved these securities or has made any finding that the statements in this prospectus or in the registration statement are correct." In other words, the Government says it takes no responsibility for the results of the investor's decision. It seems to us that there is an analogy between this problem and the problem raised by section 32 (c) (1) of the Senate bill 3580.

If a Government agency prescribed "the minimum scope of and procedures to be followed in any audit of" an investment company it could hardly escape responsibility for the results of an audit conducted in compliance with that prescription. It is possible that a competent auditor might comply exactly with rules of the Commission regarding minimum scope of audit and procedures to be followed, and yet fail to discover material facts of the utmost importance to investors. In such an event would the auditor be relieved of blame because he had meticulously followed the instructions of a Government agency? Probably not, but the Government agency could hardly escape a share of the blame in the minds of the investors whose interests had been adversely affected.

It is an ancient principle of law that a person whose conduct may be controlled and directed as to details of procedure is an employee, or servant, as distinguished from an independent contractor who may choose his own methods and who is held only for results. It is equally well established that there is a definite liability for acts of an employee performed in the course of his employment. If the Commission were to prescribe the procedures to be followed by accountants in their audits, the independence of their relationship would be seriously impaired, and if they were to be treated like employees or servants, the Commission could not escape a share of moral responsibility for any harm that might result from their acts.

It seems to us not in the interests of the Government itself to assume a share of a responsibility which is rightfully a private responsibility, resting on the shoulders of a professional practitioner.

Prescription of a minimum scope of audit would not, on the face of it, prevent an auditor from undertaking additional steps beyond the required minimum; but experience shows that there is a tendency for

minimum requirements to become, in fact, maximum requirements. It would be difficult for an auditor to persuade a client to agree to an examination more extensive than that required by the Securities and Exchange Commission. We believe that such a condition might result in a lowering of the standards of auditing practice and might dull the sense of personal responsibility which is now keenly felt by the independent certified public accountant.

Section 32 (c) (1) is a new departure in Federal legislation. We know of no Federal law providing for specification by a Government body of the procedures that professional practitioners shall follow, the manner in which they shall follow them, the steps that they shall take in the performance of their professional work. Section 32 (c) (1) of Senate bill 3580, which does provide for such dictation to professional certified public accountants, would be an innovation in Federal legislation.

It would be manifestly absurd to engage an attorney to present a case, and then prescribe exactly what statutes and decisions he should study, what arguments he should include in his brief, and how he should present them in court. He must use his judgment, with due regard for his professional standing and integrity. It would be equally absurd to instruct an engineer just how to apply the techniques of his profession in the planning and supervision of the construction of a bridge, or to instruct a physician in treating a patient. It is no less futile to attempt to lay down a pattern in advance which all certified public accountants must follow in conducting independent audits.

It is a commonplace that responsibility should carry commensurate authority. Certified public accountants bear heavy responsibilities. They risk their professional reputations every time they sign a report. They are subject to civil liabilities under the common law and under the Securities Acts. They are entitled to determine for themselves, without outside interference, what steps they will take in forming the opinions in the expression of which they incur these risks.

The independent status of the professional certified public accountant is vitally important in the performance of his function. A principal reason for his engagement to conduct an audit is to secure an objective, disinterested review of the facts and the presentation of the company's affairs, which will fully disclose information of importance to all parties at interest. The independent auditor is "in the middle." He is a kind of umpire. It is his duty to reveal the truth as he sees it, not to present a report favorable to the wishes of management, of creditors, of a governmental regulatory agency, or of any other one group. If a governmental agency had power to prescribe the scope of his investigations and the procedures which he should follow, it would acquire control and influence over the accountant which might impair his objectivity. The accountant might, to a degree at least, assume the status of an agent for the regulatory body.

A. A. Berle, Jr., now Assistant Secretary of State, in an address before an accounting society, ascribed great importance to this point. He said:

> * * * your profession * * * having freed itself from the chains of servitude to businessmen * * * may all too easily find itself merely the ciphering agency for virtually unreviewable bureaucrats. It took time to teach merchants that they could not give orders to accountants as to what their figures should show:

and the profession must never drop to the point where its members are in demand primarily because their opinions will change whenever a subexaminer, for reasons not put on the record, wishes a different arrangement of figures.

Section 32 (c) (1) would be an unwarranted and unnecessary invasion of a field of professional practice.

Certified public accountants have achieved recognition as a profession in statutes, in the courts, and in the public mind. They have built strong State and National professional organizations; they have developed technical standards of practice, have maintained and enforced rules of professional conduct, and have exercised disciplinary authority over their members. This development has been gradual over the years and is continuing. They welcome the opportunity to cooperate with the Securities and Exchange Commission and other private and governmental agencies in further improvement of accounting and auditing and corporate financial reporting.

It is offensive to the members of this profession to suggest that the work of developing its technical and professional standards should be taken from the hands of the profession itself and be assumed by a department of the Federal Government.

The effect of section 32 (c) (1), if it were administered under the widest possible interpretation, would be to make the Securities and Exchange Commission practically a partner of the accountant in every audit engagement undertaken pursuant to the terms of Senate bill 3580—a situation inconsistent with the basic concept of the practice of any profession.

If the sponsors of the bill should argue that there is no intention of applying the provisions of section 32 (c) (1) in any such extreme manner; that the Securities and Exchange Commission would administer it in a reasonable way with due respect for the considerations we have advanced, the reply must be that it is no defense of bad law to say that it will be well administered. We feel justified, therefore, in asking for the elimination of this objectionable provision from the bill itself.

Any effort to prescribe by rules and regulations the minimum scope of audit and procedure to be followed in all cases is foredoomed to failure, since every case is different from every other one. Mandate can never successfully be substituted for professional judgment.

Senator MALONEY. It is not possible for a corporation to engage certified public accountants to make a partial audit?

Mr. ANDREWS. Yes, sir.

Senator MALONEY. Is it not possible under those circumstances for there to be a failure of disclosure of things that are extremely important?

Mr. ANDREWS. That might occur.

Senator MALONEY. What do you have to say in that connection?

Mr. ANDREWS. In that connection, an auditor should state clearly what kind of an audit he has made, so that the person reading his report can understand definitely what he can depend upon and what he cannot depend upon.

Senator MALONEY. You do not think that it is wisdom on the part of the Federal Government or the S. E. C. to require a complete audit in those instances?

Mr. ANDREWS. I am not objecting to the requiring of a complete audit. If the S. E. C. wants to require a complete audit, if it feels

that nothing but a complete audit should be made, that is one thing. But telling us how to make it, where we shall exercise our judgment and where we shall not exercise it, is an entirely different proposition.

Senator MALONEY. You object to the word "minimum"; is that it?

Mr. ANDREWS. Yes; we object to that, and we object to having the procedures which we shall follow laid out for us. We might, for instance, in one case feel that it is necessary to go to great lengths in an examination. In another case there may be circumstances which make that unnecessary. For instance, the degree of the internal check in a given enterprise as compared with the lack of it in another. By "internal check" I mean, stated simply, a system of procedure which is set up so that one person checks upon another. Obviously, in one case where you have one person checking on another, you would not have to make as detailed an investigation or examination as you would in another case where there are all sorts of opportunities for mistakes. That is what I mean by the use of professional judgment.

Senator MALONEY. You are basing your assumption of course on the fact that your 19,000 certified public accountants are capable and honest?

Mr. ANDREWS. Yes, sir; and I submit, sir, that the profession as a profession is honest.

Senator MALONEY. I agree with you.

Mr. ANDREWS. You might find some cases where there have been malpractices; but I call your attention to the fact that it is not possible to make people honest by legislation. It is not more possible to make every auditor and accountant honest than it is to make every lawyer or other professional man honest. There are people who are going to be guilty of wrongdoing regardless of how much legislation you have have——

Senator MALONEY. And you cannot slow them up with traffic signs and policemen?

Mr. ANDREWS. You can slow them up; but I submit that until the profession proves unworthy of the trust of the public and until it proves itself incapable of policing its membership, it should be allowed to continue to do that.

I think I shall be able to demonstrate to you as we proceed that we have developed a profession in the truest sense of the word, and we have done it because we have followed inherent rules of honesty.

Senator MALONEY. I think that is true.

Senator HUGHES. Mr. Andrews, may I ask you this? You object to the Commission prescribing the minimum scope of the procedure to follow in auditing an investment company. If, instead of prescribing such scope, there should be a provision that every investment company should once a year, for instance, have a full audit——

Senator HERRING. You would welcome that, would you not?

Senator HUGHES (continuing). Of their accounts, and so forth; in other words, get away from these things that may be misleading, and have a full audit for the benefit of their stockholders, what would you have to say about that?

Mr. ANDREWS. Senator Hughes, we are, after all, human beings. The more work you require people to give us the better we like it. But we want to be rational about this whole matter. The accounting profession does not want anyone to feel that any member of that profession will issue an unqualified report that is not in fact unqualified

on the basis of the work done. In other words, the profession does not want to give anyone the impression that a member of that profession can be prevailed upon to make a partial check and represent it to be a complete audit. I say to you gentlemen that that cannot be done.

Senator HUGHES. In other words, if I understand you correctly, you do not want anything in the bill?

Mr. ANDREWS. That is exactly right.

Senator HUGHES. You do not want anything in the bill prescribing the minimum scope?

Mr. ANDREWS. That is right, sir.

Senator HUGHES. You would leave it to the profession?

Mr. ANDREWS. We are perfectly willing to operate in collaboration with the Securities and Exchange Commission as we have always done. I think the Commission itself will say to you gentlemen very frankly that they have never found the profession remiss in its effort to cooperate with the Commission in accomplishing the objectives toward which the Commission is working.

For instance, members of our committee of the American Institute, in the early days of the S. E. C., spent not days, but weeks and months, at the time, I believe, when Mr. Kennedy was chairman of the Commission, in developing many of the forms that are now in use by the S. E. C., designed to bring about this full disclosure which every one is interested in obtaining. We are greatly interested in full disclosures and in having audits mean exactly what they say they mean, and not to be construed as meaning something else.

Senator WAGNER. I remember the testimony given by Judge Healy on this very subject. He said that they had had some talk with representatives of accounting societies, and that the only objection they made relative to the subject was to subsection 3 of section 32. He said, "I am very hopeful that we can work out some substitute language for that."

Your substitute is the deletion of the section.

Mr. ANDREWS. In order that the committee may be fully informed as to what we have done, when this matter first arose and our committee was authorized to deal with it, we reached our own conclusions and then went to the S. E. C. in a conference with Mr. Frank, Mr. Schenker, and the chief accountant, and we told them then, very frankly, what we are telling you now. In fact, we told them the same thing. We had a very good reception and a sympathetic hearing and, as Mr. Frank expressed it, an appreciative hearing. He expressed a good deal of confidence in the accounting profession as such. We told them at the time that we thought this section should be completely deleted. We further told them that if they did not see their way clear to agree to that, we should want to appear before you gentlemen and say to you precisely what we had said to them. So I think the Commission understands that our appearance here is with full notice to the S. E. C. and in observance of the proper rules of courtesy in such matters.

Senator WAGNER. Apparently the Judge himself recognized that there was some difficulty about the provision.

Mr. ANDREWS. We hope the Judge will eventually come to the conclusion which we are suggesting here.

Senator WAGNER. The committee will have to determine eventually the provisions that are to go into the bill.

Mr. ANDREWS. I might say that a note has just been passed to me regarding a matter which had passed through my mind but which I did not mention; that is, that under our rules of professional conduct, with regard to this matter of certificates, our members cannot issue a certificate on an unqualified basis if any inadequate audit has been made. As a matter of fact, under the rules which we have adopted, if any substantial number of the assets of a corporation are not verified, the client cannot get any certificate at all. We just won't make certification of it.

Senator WAGNER. That is, under the rules of your association?

Mr. ANDREWS. Yes.

Senator HUGHES. Would he get anything at all?

Mr. ANDREWS. He would not get anything at all.

Senator MALONEY. Just a bill for services.

Mr. ANDREWS. The Senator has a sense of humor in which I heartily concur.

Senator HUGHES. My experience with public accountants has been very satisfactory and I have a high regard for their efficiency and ability. When it comes to figures I am lost, but they seem to always get through with it.

Senator WAGNER. I think we all concur in what has been said about confidence in the profession.

Mr. ANDREWS. The thing that we are particularly interested in is that you gentlemen recognize that, after all, this accounting profession is a profession. It is a new profession. There are lots of people who know little about it, but there is a general acceptance of the accountant as an independent investigator upon whom people may rely, upon whose report people may rely. I think that is more extensive than most people recognize.

I happen to be from Virginia, the city of Richmond. It is a small city of approximately 200,000 people. But it has been my privilege to serve my city as its auditor for 2½ years at the invitation of Ex-Governor Pollard, as most of you gentlemen probably recall. At the present moment I am working as comptroller. I know, as a matter of fact, that there is an acceptance on the part of the people of Virginia of the integrity of the auditors of that State. People are audit-conscious. When an auditor makes a certification they believe what he says; and the profession knows that and accepts that responsibility. You cannot get those men to do things that they ought not to do. As a matter of fact, I can tell you, gentlemen, as I go over the length and breadth of the country attending meetings of accountants, that I have observed that they lean backward on this question of ethics. As a profession they actually lean backward. They do not want to do things that are not proper. They want to have a continuance of that feeling of independence. An accountant, when he makes a certificate, likes to feel that nobody has influenced him; and there is not anybody that can, speaking now of the profession as a whole. Accountants are fully aware of their responsibility and they are trying to live up to it. Over a long period of years we have attempted to develop principles of conduct that will warrant that acceptance. We do not think that legislation would hasten the development of rules of conduct and personal integrity.

Senator WAGNER. I think we understand your viewpoint.

Mr. ANDREWS. Furthermore, I would like to say this. I do not want to presume upon the kindness of the committee; but if the Government undertakes to tell us the scope of the audit that shall be made or the way it should be made, then they cannot possibly escape the responsibility for any errors of either omission or commission that might be made.

I do not believe that you want to put the Government into the auditing business. I do not believe you do. That is exactly what you would have if the Government can say that you shall do this or shall do that. I do not believe you want to put it on that basis.

Furthermore, standards of that kind are likely to be maximum standards.

If an auditor were to do a certain thing and he thought that under the circumstances more needed to be done, he never could induce his client to pay for more than what the rules said should be done.

An auditor must exercise his judgment; and we say that this bill places the Government in a field in which it has no business, a field in which the profession has not proven unworthy of the confidence of the public, any more than other professions have. You would not for one minute, as I said a while ago, think of telling a doctor how to treat any kind of a case. You would leave it to his judgment. If you are not willing to take that step in a profession in which men's lives are involved, why should you take that step in relation to the practice of accounting? I do not think you should tell us how to carry it on any more than you should tell a doctor how to treat his cases.

I should like very much to ask the other members of the committee who are here to be recognized.

The first gentleman is John K. Mathieson, president of the American Institute of Accountants.

Mr. MATHIESON. I think there is nothing more to add, Senator. I appreciate your courtesy in carrying over in order to hear us.

Mr. ANDREWS. The others are Mr. Samuel J. Broad, vice president, New York; Mr. C. Oliver Wellington, a member of the executive committee, also of New York; and Mr. John L. Gerry, our secretary, also from New York.

We are most grateful to you for the time you have accorded us. I hope that we have made ourselves clear, and I would like to leave you with the understanding that our participation here has been in the spirit of cooperation. We have no quarrel with anyone. We want only to be allowed to continue to cooperate with the S. E. C., and to leave our professional responsibilities on the professional basis. We believe that the desired results can be much more readily accomplished upon that basis than otherwise.

Senator WAGNER (chairman of the subcommittee). We will recess until 2:30 this afternoon.

(Whereupon, at 12:35 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTER RECESS

The subcommittee resumed at 2:30 p. m., on the expiration of the recess.

Senator WAGNER (chairman of the subcommittee). The subcommittee will come to order. Mr. White?

Mr. White. Yes; Mr. Chairman.

Senator Wagner. Very well. We will be delighted to hear from you.

STATEMENT OF JAMES N. WHITE, OF SCUDDER, STEVENS & CLARK, INVESTMENT COUNSEL, NO. 10 POST OFFICE SQUARE, BOSTON, MASS.

Mr. White. My name is James N. White and I am a general partner of the firm of Scudder, Stevens & Clark, investment counsel.

Senator Wagner. Where are they located?

Mr. White. In Boston, New York, and Philadelphia. This is in regard to title I.

Senator Wagner. All right, you may go ahead.

Mr. White. Our firm is sponsor and manager of two openedd investment trusts which were formed for the purpose of giving investment counsel to small investors who wished our advice. These funds have never been publicly offered or underwritten and have been issued without any loading charge. Previous testimony on title I has indicated that there was no desire on the part of the framers of the bill to discourage this type of trust, and a limited exemption in the matter of special treatment in connection with control of the board of directors has been offered funds of this type and the bill. We believe that this exemption could properly be broadened and the funds to which it might apply more specifically defined.

The Scudder, Stevens & Clark fund was organized under the laws of Massachusetts in April 1928 for the purpose of taking care of small investors who wanted to employ the services of Scudder, Stevens & Clark. For 8 years we had been trying to supervise funds of $25,000 or less and had found that they were not only unprofitable to us but that we could not invest them to as great advantage as our larger individual accounts. Therefore, in 1927 we formed an investment counsel trust as an experiment in investment trust management. The first million dollars that we managed in investment trust form came from individuals who were previously clients of our firm most of them comparatively small clients.

Since this fund was formed in order to make investment counsel available to the small investor, we endeavored to make his position as identical as possible to that of our individual larger clients by the following stipulation:

(1) The subscription price and the redemption price should be the approximate liquidating value of the fund at the time of subscription or redemption.

(2) There should be no loading charge, and our firm should not profit from the fund in any way except through the management fee of one-half of 1 percent of the principal per annum, the same rate paid by individual clients.

(3) No sales commission should be paid to any dealer or underwriter.

(4) The portfolio should be so balanced by ownership of short- and long-term bonds and preferred and common stocks as to represent a suitable investment medium for the entire capital of a small investor.

(5) Not more than 5 percent of the gross value of the fund should be invested in any single security except obligations of the United States Government.

(6) The fund should have no senior securities outstanding.

(7) Except in rare instances, the investments of the fund should be confined to seasoned securities of nationally known companies listed on a national security exchange and readily marketable.

Since the date of its organization in 1928, the Scudder, Stevens & Clark fund has always operated within these limitations. The stock has never been publicly offered or underwritten and we have paid no sales commissions to any brokers or dealers for distributing its shares. Nevertheless, the fund has grown steadily and subscriptions have exceeded redemptions in each year of its existence. Almost entirely because of voluntary subscriptions of individuals wishing the management of our firm, the fund now amounts to about $11,500,000, and we have about 1,000 stockholders. Many of the shareholders have their entire capital invested in this fund, a fact of which we are very conscious in reviewing our investment policy.

Shares are issued at liquidating value plus a premium of 1 percent. This premium is not a load but accrues to the assets of the fund. In the same way, shares are redeemed at liquidating value less a discount of 1 percent which remains in the fund. The purpose of the premium and discount was to discourage trading in the shares. For this purpose also there is a provision that shares purchased must be held at least 30 days.

Continuity of management is assured by the capital structure of the corporation. The principal officers and all but one of the directors are members of or associated with the firm of Scudder, Stevens & Clark, and 90 percent of the voting or class B stock is held by individuals connected with that firm. This class B stock is identical in every respect with the class A stock held by the public except for the voting privilege and the fact that it is not redeemable. It has to be offered to the management.

None of the officers or directors of the corporation may have dealings with it as principals in the purchase or sale of securities. Furthermore, to assure complete protection for the stockholders, the bylaws require that all securities, moneys, and funds of the corporation must be entrusted for safekeeping to a national bank or trust company as depositary.

Our experience with the Scudder, Stevens & Clark fund in the first few years of its operation indicated that it filled a definite demand for an investment trust of this kind, but it also demonstrated an important limitation on its usefulness. In our work as investment counsel we attach great importance to adopting our investment program to the individual requirements of each client, and no two accounts are handled exactly alike either from the point of view of a general investment program or security selection. Of necessity, however, every person who employs our services through the medium of a participation in the Scudder, Stevens & Clark fund receives exactly the same investment program.

We discovered that the investment program of the Scudder, Stevens & Clark fund failed to fill the requirements of some investors whose primary interest was neither current income nor relative stability of principal or purchasing power, but whose main objective was to build up their investment funds over a period of years. To meet this demand we formed another investment trust in March 1929. The features of this fund were identical with those of the Scudder, Stevens

& Clark fund except in two respects. In the first place, it was intended that this fund would pay no dividends to participants and that all earnings would be reinvested in securities. In the second place, it was the announced policy that practically all of the assets would be invested in equities under almost all conditions.

While both the Scudder, Stevens & Clark fund, and the other smaller fund are corporate in form, in reality they are commingled funds of the small clients of Scudder, Stevens & Clark. We have made it clear to stockholders that they are welcome at any time to call at our offices and to discuss with responsible members of our organization not only the affairs of the corporation in which they are interested but also their personal financial problems. Many stockholders have availed themselves of this invitation and have discussed with us insurance, taxes, and even business and sometimes personal problems. We regard this a part of our job as managers of their invested capital, and we make no charge for our services in this connection.

The two investment trusts which we manage represent only a small fraction of our total clientele, but we hope they will continue to grow gradually in the future as they have in the past. We do not claim that they represent the complete or the only solution of the problem of the small investor, but we feel that we are making a contribution toward this objective. Ours is not the only investment trust of this type. The investment counsel firm of Loomis, Sayles & Co. offers shares of similar characteristics to small investors seeking their management. Other investment counsel firms tell us that they contemplate organizing such funds for the same purpose in the future. This is a natural adjunct of investment counsel and is available to small investors on reasonable terms and we believe, from the testimony before this committee and from certain provisions in the bill itself, that there is no intention to discourage this type of investment trust.

There are many provisions of title I which seem to me needlessly restrictive and harsh. The committee has been listening to criticism of the bill as a whole for many days, however. I don't want to cover ground already well trodden, nor do I feel competent to discuss many of the provisions of the bill. I do want to mention certain provisions which would seriously affect if not absolutely impair the operation of the Scudder, Stevens & Clark funds which I have described.

First of all are the provisions which would require our funds to have a majority of independent directors. That requirement would defeat the very purpose for which our funds were organized.

Senator Wagner. How about having assurance of some independent directors?

Mr. White. You realize I know that my point is there of being simply a case where the stockholders chose our management. The point against having some independent directors is, first, that you get a divided responsibility, and then, secondly, even with a minority of independent directors I think our firm or any investment counsel firm would think very seriously before they went against the advice of a minority.

Senator Wagner. You are in touch with them or at least there is a relationship between you and your shareholders?

Mr. White. They came to us.

Senator Wagner. There is a difference there, no doubt.

Mr. White. We think so; yes.

Senator Hughes. Is there a majority of your directors now who are independent?

Mr. White. All but one are either members of our firm or on our staff. That is, one out of nine, I think; and he is affiliated with us in the way of being a sort of client, I might say.

The holders of stock in our funds have purchased their interest because, rightly or wrongly, they wanted to have Scudder, Stevens & Clark management. They remain stockholders in our funds only because they continue to want our management; otherwise, they can redeem their shares, as they sometimes do, and look elsewhere for investment management. If a majority of directors are truly independent, however, it is possible that the stockholders in our funds will have forced on them the choice of accepting an investment management which they have not chosen and do not want, or of getting out of the fund.

Senator Hughes. If I understand the bill it permits you to have a majority of the directors.

Mr. White. It permits us to have a majority, and of course you can always work with a majority, but from the point of actually running the fund, we find that our one independent director has a great deal of weight with us, and we hesitate, even with eight against one, when he feels strongly about a matter, to vote him down simply because we outnumber him. He happens to be the president of a trust company, and we defer to him as much as we possibly can in order to get the benefit of his judgment. It would not be a crushing blow or anything like that, but what our stockholders really want is to get a reflection of our judgment as investment and research counsel. It is a question I would be perfectly willing to put up to our stockholders.

There is another and perhaps more serious objection to the independent director requirement. It would mean a division of investment responsibility between our firm and the outside directors. Our advice might not be followed, with the result that our clients, the fund stockholders, would not be getting what they believed they were getting and wanted to get. Again, the divided responsibility might result in compromises with which neither we nor the independent directors would be satisfied—or in constant changes of direction which would be harmful. This point, it should be noted, would apply as well to a provision requiring a minority of independent directors—for I think any firm of investment counsel would necessarily hesitate to follow an investment course opposed by independent minority directors, no matter how sound that course should appear.

I think that there is a different argument against the requirement of independent directors—one which is entirely selfish but nevertheless valid. Our funds were started by us; we have done the work and spent the money involved in organization; and our clients are the shareholders.

It seems distinctly unfair that independent directors, or for that matter a majority of the shareholders, should hand the results of this work of ours, and the goodwill of our clients, over to another firm of investment counsel or investment managers. This is particularly true since any shareholder who ceases to like our management, who doesn't want to continue in substance as a client of ours, can always redeem his stock.

So much for the independent directors' requirement.

Next I would put the provisions which makes it impossible for us to manage more than one fund. Section 10 makes it impossible to continue to manage more than one fund; section 11 makes it impossible to start a new fund. We now manage two trusts with different investment objectives. It is rather probable than otherwise that it will prove desirable to form an additional trust or trusts to meet changes in investment conditions or to fulfill the needs of other groups of investors. For example, for some time we have had under consideration the formation of a trust, subscriptions to which would be strictly limited to our regular clients, which would invest in the securities of smaller, less well-known and less marketable companies than those whose securities we generally recommend.

For practical reasons, mostly of marketability, we could not recommend the securities of such companies extensively among our individual clients, and a new trust would be the only satisfactory way to handle the matter. In the same way, although we could not advise our clients individually to buy commodities in case of extreme inflation, we could do so through the medium of investment trusts. As long as there were no dealings between the funds, we see no objection to permitting investment counsel to manage several, and we think our clients might be somewhat shocked if they felt that a law stood in the way of our giving them our best independent advice.

Finally, I want to mention specifically one other feature of title I—the provisions requiring registration not only of an investment trust but also of its investment counsel, manager, officers, directors, and other affiliated persons.

Registration means not only disclosure; it means subjection to regulation. In dealing with the regulation of investment counsel proposed in title II, I will point out the dangers to our profession which we fear are inherent in governmental regulation. These same dangers exist whether regulation of our profession is imposed under title I or title II. It ought to be possible for us to serve our clients by means of a commingled fund without subjecting all our affairs, and our clients' affairs, to the drastic regulatory and investigatory provisions of title I.

The bill does contain one provision which recognizes, perhaps, that such investment counsel-sponsored trusts deserve recognition. A limited exemption for such trusts is granted under paragraph 3 of section 10 (a). We think that the definition of such types of trust could be improved upon and that the exceptions afforded such a type of trusts should be extended.

As to defining such a type of trust, we think that a trust to qualify should meet the following conditions. Some of them are more restrictive, some less restrictive, than those now appearing in section 10 (a) (3):

1. The trust should be an open-end investment company.

2. There should be no sales load on securities issued by such investment company, and no sales or promotion expense should be incurred by it.

3. It should be managed by an investment counsel who is primarily engaged in no business other than that of investment counsel. Possibly it should be required that the name of the investment trust should contain the name of the investment counsel who sponsors it.

4. Such investment company should have no manager other than such investment counsel and such investment counsel should not

receive a management fee in excess of 1 percent of such company's net assets averaged over the year or averaged over definite dates within the year.

5. For such a fee, the investment counsel should provide both advice and executive management, so that the trust is not subject to expense for compensation of officers or directors.

Senator HUGHES. Am I right that you charge now one-half of 1 percent?

Mr. WHITE. That is right.

6. All securities and cash of such company should be entrusted for safekeeping to a national bank or trust company, under appropriate safeguards.

7. The trust should have only one class of stock, all of which should be voting.

8. Without the affirmative vote of the holders of the majority of its capital stock on any given transaction:

(*a*) The trust should have no dealings with any other investment company managed by its investment manager or any affiliated person of such manager.

(*b*) The trust should have no dealings in securities with any officer, director, or partner, or affiliated persons of its investment manager or such investment manager itself.

(*c*) The trust should have no dealings in securities with any officer, director, or affiliated person of the trust.

We think investment counsel-sponsored trusts of the type outlined deserve to be fostered rather than hindered. In his testimony Judge Healy spoke of promoting the dignity of investment trusts. What we ought to develop, he said, is "a group of expert investment trust managers who do not make their profits from originating and distributing types of securities, styled principally for their sales appeal, but from wise and careful management of the funds entrusted to them." Our funds seem to us to fall within Judge Healy's description. The law as passed ought not to interfere with our management of one or more trusts, designed to fit different needs, which can meet the qualifications we have roughly outlined above.

In addition, we do not feel that title I should subject our investment counsel business and our own personal clients to disclosure of their private affairs.

I want to say one more word, and that is that we do not propose to raise our charge to the trust if these stipulations which we have outlined should become effective.

Senator WAGNER. You apparently have had considerable experience in the operation of investment trusts. Let me ask you this question: Do you think that there is justification for a load charge of 10, 12, 14, or 15 percent?

Mr. WHITE. I think there is a limitation somewhere, Mr. Chairman.

Senator WAGNER. Where do you think it is?

Mr. WHITE. That is an awfully hard question to answer. I am not strictly in the business of running an investment trust.

Senator WAGNER. I thought you would have an opinion about that; 8, 9, or 10 percent seemed awfully high, to me. Of course I am not a banker.

Mr. WHITE. I think you are getting into the higher brackets there.

Senator WAGNER. There is one other thing you said. You said that you contemplated organizing an investment trust which was to have a different investment objective——

Mr. WHITE. In this case it would not exactly have a different objective. It would work in a different type of investment, a type which for our purposes can only be handled through a group investment. If you want to know the reason, it is because a company may——

Senator WAGNER. Not unless you are willing to disclose it.

Mr. WHITE. Oh, yes. A company may be a very attractive investment and its shares may have a very limited market, so that if you recommended it to two or three hundred people you would really be locked into it; you would be unable to dispose of it. Whereas with a trust, which would not have to deal with two or three hundred people, it could make small sales on the market and could dispose of it much better.

Senator WAGNER. The reason I asked was because I wondered whether the different objective was that this was to be more of a risk or venture, rather than diversified, safe investments.

Mr. WHITE. No; not necessarily. I think that is a very good reason for lumping a number of securities carrying greater risk.

Senator WAGNER. Except that that is an entirely different type, is it not, from the diversified trust of which you spoke here?

Mr. WHITE. Yes.

Senator WAGNER. In relation to your own trust, in that the shareholder of that kind of trust ought to be pretty definitely informed, if he is going to take a chance, that you are risking his money on a venture. Don't you think so?

Mr. WHITE. Yes. I think the shareholder should know the type of trust he puts his money into, even if after that he leaves it to the discretion of the management.

Senator WAGNER. Yes; but he ought to know what the management contemplates doing with that money?

Mr. WHITE. Yes; I believe he should. There is no question about that.

Senator WAGNER. Thank you very much.

STATEMENT OF ROBERT H. LOOMIS, PRESIDENT, LOOMIS, SAYLES & CO., INC., BOSTON, MASS.

Mr. LOOMIS. My name is Robert H. Loomis and I am president of Loomis, Sayles & Co., Inc., investment counsel, with the head office in Boston. I am also president of the two open-end investment trusts managed by our company.

In view of the fact that our two investment trusts are in most respects substantially the same as those of Scudder, Stevens & Clark, I would like to state that I am in accord with the testimony already submitted by Mr. White of that firm.

In order to avoid repetition I shall confine my remarks particularly to sections 10 and 22 of title I of this bill.

Under section 10 of this bill a majority of the directors of investment trusts must be independent of the management. Under subsection (b), however, an attempt was made to qualify these restrictions, allowing investment advisers to have a majority under certain conditions. During the testimony on this section of the bill, I believe Mr. Schenker remarked that it referred to investment trusts of the type managed by Scudder, Stevens & Clark. I believe he also remarked favorably on this type of trust. It was my impression that he did not intend to interfere with the operation of this type of fund. By his

remarks, he singled out this type as being in a rather unique position. While Mr. Schenker may not have intended to interfere with the operations of such trusts, I would like to explain briefly to the committee the effect that this legislation will have upon the Loomis Sayles Mutual and Loomis Sayles Second funds, which we manage, and which in all important respects are similar to the Scudder, Stevens & Clark investment trusts.

In this bill we are referred to as "investment advisers." We have been furnishing investment advice to individuals on the management of their private funds since 1925. Not long after we started operation, we found that investors of relatively small means—from $1,000 to $20,000—were coming to us and asking if we could not furnish them with investment advice. We found it impractical and impossible to deal with such amounts in a segregated account. Therefore, in order to provide service for these smaller investors, we organized, on November 5, 1929, an investment trust known as the Loomis Sayles Mutual Fund. In April of 1935 we organized another investment trust known as the Loomis Sayles Second Fund. These trusts were managed under the same investment policy as are our private accounts. The trusts, of course, are under the jurisdiction of the S. E. C.

Permit me to emphasize again the fact that these trusts were formed in order to furnish a vehicle of investment for those investors who wished to obtain Loomis-Sayles investment advice. People buying these shares felt that they wanted what we had to offer. They wanted our investment advice and our management. Under the present bill, however, only under certain peculiar conditions can a majority of the directors of these trusts be affiliated with our firm. The shareholders did not buy into these trusts to secure a management group independent of our company. They wanted our management or they would not have bought the shares; and please remember that at any moment, should they decide they no longer were interested in having their money commingled in a fund managed by us, they can get the liquidating value of their shares at any time subject only to a 2 percent redemption charge if the shares are redeemed within 3 years from the date of purchase. This is to discourage trading in them.

According to section 10, a majority of the directors of these trusts can be members of our firm, providing the sales load on the securities issued does not exceed 1 percent and providing the investment adviser does not receive a management fee exceeding one-half of 1 percent. In other words, if we wish to charge over one-half of 1 percent management fee, we are compelled to go outside of our organization for a majority of the board of directors, thus placing the control of the funds in the hands of someone not selected originally by the stockholders.

The investor is prevented by law from investing in an investment trust for which we act as manager-adviser if we feel that 1 percent is a proper fee. Even though he stood in line at the door we could not furnish him what he wanted.

When the stockholder purchases a share in these funds, he knowingly selects as manager for these shares a board of directors composed of members of our organization. Since the stockholders made his selection of directors originally from among the personnel of our organization, he would, under this bill, be forced to elect and reappraise a new board containing an independent majority. He would have to decide

whether or not he wished to accept their management policy or redeem his shares.

At this point I would like to submit two charts to be made a part of the record. The first chart indicates that a share of Loomis Sayles Mutual fund purchased at $75 when the fund started on November 5, 1929, had a liquidating value of $85.23 as of December 31, 1939. Total dividends paid during this period amounted to $59.60.

The second chart shows that a share of Loomis Sayles Second fund purchased at $25 when the fund started on February 6, 1935, had a liquidating value of $36.14 as of December 31, 1939. Total dividends paid during this period amounted to $6.40.

I submit the records of these funds simply to give your committee an idea of what these investors received from the purchase of shares in our funds, which have been completely under our supervision.

I would also like to state that when these shareholders bought these shares they knew that the management fee to be charged on the funds was to be 1 percent annually. The figures just mentioned are after the deduction of this 1 percent annual management fee, plus bank custodian charges, and taxes. There was established, therefore, a contractual relationship between the purchaser of the shares and the managers. We have never charged a "sales load" on these shares. Every dollar of the investor's money has gone directly into the funds. However, we are now to be restricted by this bill to a management fee of only ½ of 1 percent, instead of the agreed 1 percent unless a majority of the board of directors of the trusts are of the so-called independent type.

While we cannot believe that the S. E. C. meant to interfere with the manner in which these trusts are run, nevertheless the bill does do so. Fortunately, the stockholders seem to like the way we run them.

It is only natural that if we wish to continue and prosper as investment counsel, first of all, we would wish to have associated with us men of ability and sound judgment. It is only natural that when we organize and offer to smaller investors an investment trust under our own name, we would wish to have this managed properly and entirely in the interests of the stockholders. I could, perhaps, impressively mention the background of some of the directors of these two trusts. It would appear unnecessary since they represent Loomis, Sayles management, and that is what the investor has selected.

Important also is the fact that there has never been any charge to the trusts for the services of the directors and officers, nor any sales-promotion expenses, nor for secretarial services. As has been pointed out by others, the difficulties that would be imposed by this bill on the securing of competent independent directors, might well result in an additional expense.

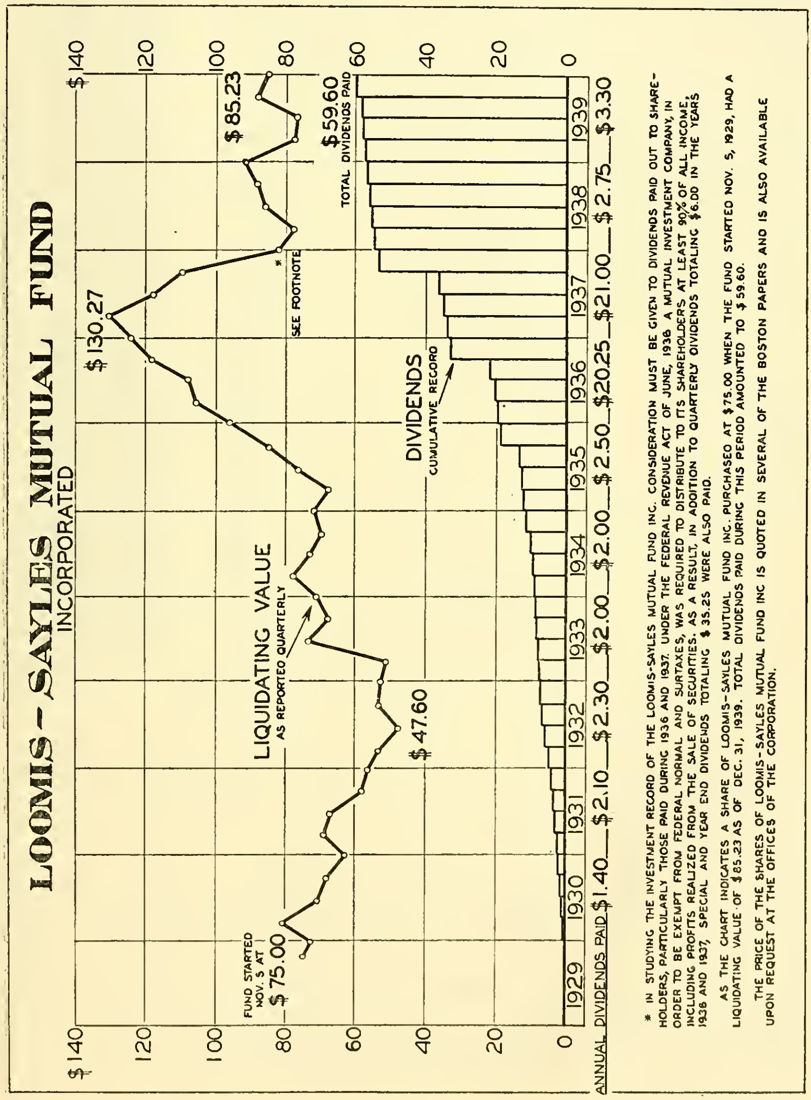
Subsection (d) of section 15 requires that a majority of the independent members of the board of directors must approve of the contract with the advisers; so I guess the stockholders in our funds cannot get what they want after all!

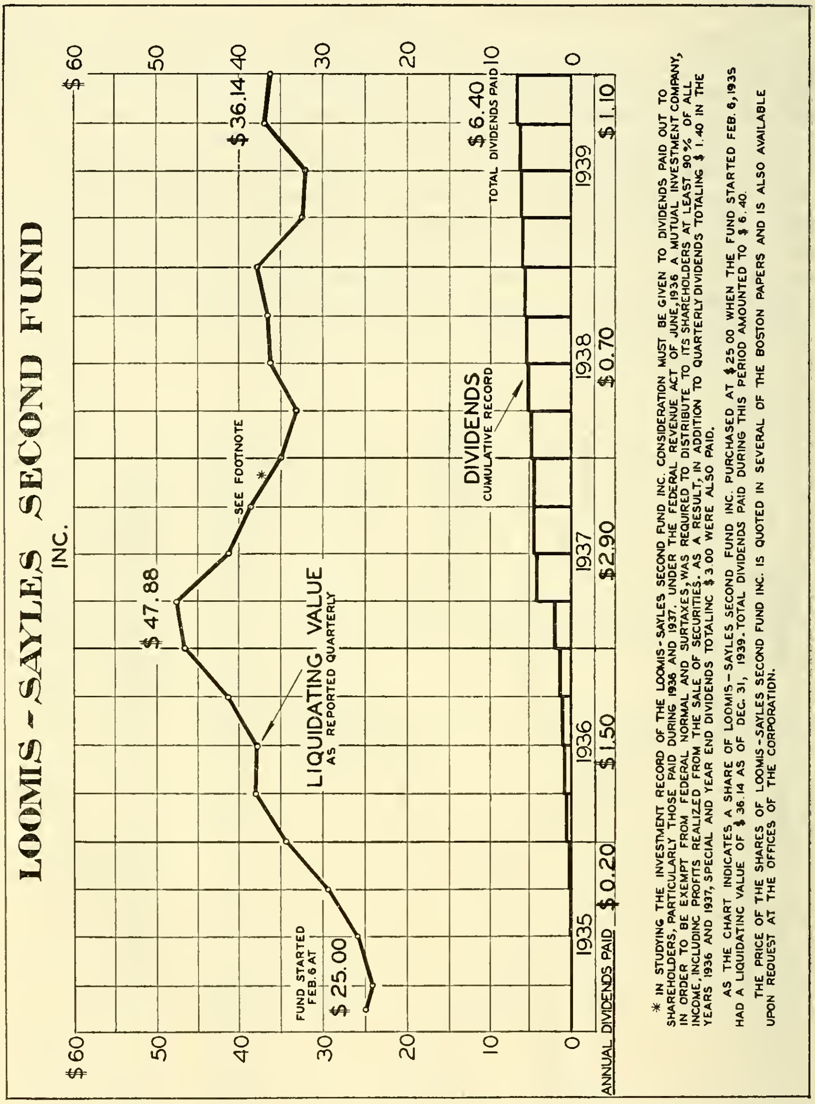
Section 22 (d) (2) states that the S. E. C., by rules and regulations, can prohibit restrictions upon the transferability and negotiability of any redeemable security. When the stockholders of our two funds bought these shares, they knew that they could sell them only to the trusts themselves. The shares are redeemable at any time. It was the intention of the management, for the protection of the share-

holders, as well as of themselves, to restrict the transfer of the shares in this manner. If it were not possible for the shareholder to secure an actual liquidating value of his shares, if he so desired, such a restriction might well be improper. However, we cannot see any justification for a change in this contractual arrangement already agreed upon by the purchaser of the shares of our funds.

Section 10 (b) (3) (a) raises the question of whether we would even qualify under this subsection since it limits the exemption to investment advisers engaged in no business other than that of investment adviser, and we, as well as Scudder, Stevens & Clark, do act as managers of investment trusts. I maintain that this is an unnatural divorce and not in the interest of the investors themselves.

(The charts referred to and submitted by the witness are as follows:)





Senator WAGNER. This, I take it, is what is generally known as a diversified trust?

Mr. LOOMIS. An open-end.

Senator WAGNER. It is open-end, yes; but do you go into any risky ventures?

Mr. LOOMIS. No; ours is the usual diversified type.

Senator HUGHES. You do not pay your directors anything, you say?

Mr. LOOMIS. No.

Senator HUGHES. You charge 1 percent, do you?

Mr. LOOMIS. Yes.

Senator HUGHES. Is that 1 percent of the earnings?

Mr. LOOMIS. No; 1 percent of the asset value.

Senator HUGHES. That pays the officers?

Mr. LOOMIS. Yes, sir.

Senator HUGHES. And the other expenses?

Mr. LOOMIS. It pays the secretarial expense; it pays most of the legal expenses; it pays rent, light, and all the expenses except custodian charges and taxes. I think that includes them all.

Senator WAGNER. Where do the taxes come from?

Mr. LOOMIS. The trust has to pay those.

Senator WAGNER. They come out of the trust, of course?

Mr. LOOMIS. Yes.

Senator WAGNER. Are there any other questions? (No response.) Thank you very much.

STATEMENT OF DOUGLAS T. JOHNSTON, PRESIDENT, JOHNSTON & LAGERQUIST, INC., NEW YORK, N. Y. AND VICE PRESIDENT OF THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA

Mr. JOHNSTON. The statement which I am making is purely introductory to the testimony to be given by other representatives of the investment counsel profession and is designed to outline the points that will be covered by them in more detail. My remarks will be very brief.

The bill which is the subject of the present hearing is aimed "to provide for the registration and regulation of investment companies and investment advisers and for other purposes."

Title I of the bill covers investment companies; and title II, the hearings on which are now starting, covers investment advisers.

The definition of "investment adviser" as given in the bill, in spite of certain exclusions, is quite broad and covers a number of services which are entirely different in their scope and in their methods of operation. For example, as we read the definition, among others, it would include those companies which publish manuals of securities such as Moody's, Poor's, and so forth; it would include those companies issuing weekly investment letters such as Babson's, United Business Service, Standard Statistics, and so forth; it would include those tipsters who through newspaper advertisements offer to send, for a nominal price, a list of stocks that are sure to go up; it would include certain investment banking and brokerage houses which maintain investment advisory departments and make charges for services rendered; and finally it would include those firms which operate on a professional basis and which have come to be recognized as investment counsel.

Just why it is thought to be in the public interest at this time to require all the above services to register with, and be regulated by, the Federal Government we do not know.

At a hearing in Washington 2 years ago we were told that there was incomplete information as to how many and what companies and firms were included in the investment advisory field. Possible abuses that might exist in the field were mentioned rather than specific ones definitely requiring action.

We all know that abuses exist, or may occur, in practically every field of endeavor; existing laws against fraud already cover the most flagrant, and the balance ordinarily do not require Federal regulation in order that the public interest may be best served.

At that hearing we were asked if we did not think that the taking of a census to determine what the field consisted of would be a good thing. Having at that time given little thought to the matter we either agreed that it probably would, or at any rate raised no objection except to point out the difficulty of making any such census all-inclusive.

Title II of the present bill is a far cry from the simple census proposed at that time. If a simple census can develop into a bill with the broad regulatory provisions included in title II, can one not be excused for wondering how the discretionary powers given in the bill would actually be used?

If there exist abuses in the broad field of investment advisers, then first, those abuses should be specified; and second, it should be considered whether the public interest requires the enactment of Federal legislation to correct those abuses; or whether some other and perhaps better and more effective way can be found. Here the cart would seem to be before the horse—a bill is being proposed to include all investment advisers with certain important exceptions, not to correct predetermined abuses, but to discover whether they exist.

I have mentioned certain important exceptions or exclusions in the definition of "investment advisers"; one of the principal of these is lawyers. Probably in the aggregate more investment advice is given by lawyers than by all other advisers combined. I only want to point out that in so acting they are not functioning strictly as lawyers. So far as I know, no courses on investments are part of a law school curriculum, nor in passing bar examinations does a lawyer have to pass a test on investment. So if a census were to be taken, why not include lawyers?

There is one other point that I would like to bring to your attention. In the attempt to cure many of the abuses that have existed in the securities markets Congress has quite properly gone to the source of many of the troubles, namely the original issue of securities. Investment advisers do not issue securities. They only advise as to securities already issued. If they advise one person to sell a certain security some other person must buy it. If the seller is benefited the purchaser may be hurt, but as far as the general public is concerned the matter washes out. The bringing out of a new issue of securities however if it is either unsound itself or unsoundly issued, does adversely affect the public interest.

I, and those testifying immediately after me, belong to the profession of investment counsel, which has been included in title II of the bill, by definition. We speak only for those practicing in the profession of investment counsel and do not attempt or presume to speak for the other groups also included in the bill by the same definition. We shall attempt in our testimony:

(1) To describe the profession of Investment Counsel for the benefit of those of the committee why may be unfamiliar with our functions and how they are performed;

(2) To show why, in our opinion, regulation of investment counsel at this time would not be in the public interest but possibly actually against it; and

(3) To bring to your attention the steps that have already been taken within the profession itself toward self-regulation.

Senator WAGNER. Thank you very much, Mr. Johnston.

Senator HUGHES. On page 96 of the bill there is a statement of facts found under paragraphs 1, 2, 3, and 4. Have you anything to say about that, as to whether those are correct?

Mr. JOHNSTON. I felt that they were not very specific as to possible abuses.

Senator HUGHES. Will someone else cover those things?

Mr. JOHNSTON. Yes; they will be covered later.

STATEMENT OF CHARLES M. O'HEARN, VICE PRESIDENT AND DIRECTOR OF CLARKE, SINSABAUGH & CO., INVESTMENT COUNSEL, CHRYSLER BUILDING, NEW YORK, N. Y.

Mr. O'HEARN. I am Charles M. O'Hearn, vice president and director of Clarke, Sinsabaugh & Co., investment counsel, with principal office at New York in the Chrysler Building. We are a privately owned corporation.

We believe this bill proposed for the regulation of the investment-counsel profession is against public interest and will be seriously damaging to our business.

We should like to describe our profession. Investment counsel performs very definite functions quite different from those performed by many firms or businesses which are also included under title II of this bill.

It is a personal-service profession and depends for its success upon a close personal and confidential relationship between the investment-counsel firm and its client. It requires frequent and personal contact of a professional nature between us and our clients. We must know them well. It is the professional character of our business which establishes the basis for charging fees. There are many services we render which cannot be directly related to the amount of our compensation. As a matter of fact, our fees are charged as a percentage of the total market value of the securities under supervision. We do not share profits.

The financial program and objectives of an investment trust are predetermined before it begins to operate. Its operating problems are primarily those of security selection and timing of action. With us, however, these are not the first consideration though they are very important. Our first task is to prepare and maintain for each client a broad plan for his general financial objectives and for the methods appropriate to their accomplishment. We cannot advise him properly on the development of his financial affairs in the future without such a plan. In making the plan, we must determine the soundness of the relation of his income to his standard of living. We must also consider his capacity to assume financial risks, his probable future expenses for educating his family, the number of his dependents, and so forth.

We must establish with each client a relationship of trust and confidence designed to last over a long period of time because economic forces work themselves out slowly. Business and investment cycles last for years and our investment plans have to be similarly long-range. No investment counsel firm could long remain in business or be of real benefit to clients except through such long-term associations.

Our relationship with each client requires a direct and continuous supervision over the securities in his fund. Most firms follow the

same general procedure. In our firm, we keep separate records for each client containing a list of all his securities. The client's identity is represented by a number to preserve the confidential relationship. The records also reflect all changes which take place or are recommended either as a result of our initiative or, as sometimes happens, as a result of a client's initiative. Having this complete record of our client's financial position available at all times, we are able to take appropriate action in the light of new developments.

Since we have a cold-blooded, objective approach, we tend to exercise a restraining influence that discourages speculation and helps clients to avoid hasty and emotional decisions.

I should like to say something about the mechanics of our operation.

Within the framework of our plan for him and based upon the information in our records, we make recommendations from time to time to each client for changes in his account. These are always designed to place it in a stronger position with respect to his major objectives. He considers these recommendations and accepts or rejects them. He may then act upon them himself or instruct us to send them to his broker who executes them accordingly. Some clients prefer to have us transmit our recommendations to their brokers directly in the first place. When purchases and sales have been confirmed, corresponding changes are made in our record of the client's holdings. We make frequent reports to the client about his position, his income, the general economic situation, the position and prospects of particular securities, and about anything else relating to his financial affairs on which he may desire comment. In these reports, we also comment, as the need arises, upon the progress which is being made in executing our long-term plan for his affairs.

This is the sum of what we do. We do not take custody of securities or of cash balances. We do not act as brokers. We do not receive any income directly or indirectly from any broker or dealer in securities. We have no incentive to suggest unnecessary transactions, as our fees are not affected by the turn-over of securities in an account.

I should like to emphasize the conservative, rather than the speculative, nature of our approach.

As we conceive our function, it is primarily to conserve a client's means. Our objective is to maintain and, to the extent which is consonant with his ability to assume risk, to raise his standard of living in terms of the income received by him over a long period of time. It is not our objective to make money for him in a series of spectacular moves. Of course, conservation in the financial sense requires an effort to achieve gains in order to offset the inevitable losses resulting from unforeseeable changes in economic and industrial conditions. Also, investors face such risks as a possible rapid rise in the cost of living. For persons depending substantially upon fixed income returns, as do most of our clients, this requires an attempt on their part to seek a return beyond the amount permitted by general interest rates. Within these limits, however, we do not seek to "make money" for our clients.

An essential feature of the conservative approach is limitation of risks. It is axiomatic, of course, that all investing is an assumption of risk for the promise of return. One investor however may be able to assume large risks for the prospect of commensurate reward while

the widow and the orphan should not be speculators in even the best wildcat propositions. The ramifications of this principle however often get lost in the shuffle. Therefore, the need to evaluate the capacity of an individual to assume risks is the chief reason for a carefully studied and balanced investment plan.

It will be clear to the members of the committee that the heart of the service we offer to our clients is experienced and well informed judgment. No act of Congress nor any power of the Federal Government can add or detract one iota from our experience or our judgment. Judgment, carefully trained, sincerely applied, and well supported by adequate data, is our stock in trade: Judgment of the client's circumstances and of the soundness of his financial objectives and of the risks he may assume. Judgment is the root and branch of the decisions to recommend changes in a client's security holdings. If the investment counsel profession, as we have described it, could not offer this kind of judgment with its supporting experience and information, it would not have anything to sell that could not be bought in almost any bookstore.

The requisite experience and training we try to assure by the care with which we select our associates and our staff. In addition, however, our judgment must have the benefit of research to permit us to make intelligent decisions. We employ research staffs to study the general economic situation at home and abroad; to study and know industries, their problems and their prospects; to investigate particular companies, and over long periods of time and under varying conditions, to know their character, methods, managements, soundness, and prospects. In addition, also, we study the position of particular securities in relation to all of these other factors and in relation to the prospect that they will provide some cash return in the form of dividends or interest in the future.

This proposed bill provides for the registration and regulation of investment companies and of investment advisers. It seems to us that investment advisers were "brought along with the crowd." We fail to see that there is any essential similarity between the investment trusts and investment advisers.

All the testimony about abuses presented to this committee has been confined to the investment trusts. It seems to us, therefore, that legislation affecting us is proposed on the basis of actual or inferred evidence relating solely to investment trusts. Furthermore, our clients are not unsophisticated in financial matters. They are resourceful men and women of means who are very critical in their examination of our performance. If they disapprove of our activities, they cancel their contracts with us, which eliminates our only source of income.

We are not in a position to pass upon the charges which have been leveled against the investment trust business. We do know that a large portion of that business is motivated and governed by the same principles and sense of responsibility that govern our operations. However, we also know that the desirability of some regulation for the investment trusts has been pretty well established and has been accepted by the investment trusts themselves. The implication is that there is a need for such regulation. We are lumped with investment trusts in the bill in a way which attaches this implication to us as well. This is damaging to our profession. To paraphrase an old

saying, "If you give an investment counselor a bad name, you might as well close up his shop."

I should like to attempt to distinguish investment counselors from others who aid the people to invest funds.

When investment advisers were included under this proposed legislation, many persons and firms were included who, in our opinion, are more notable for the differences between them than for their likenesses.

We are quite clearly not "hit and run" tipsters, nor do we deal with our clients at arms' length through the advertising columns of the newspapers or the mails; in fact, we regard it as a major defeat if we are unable to have frequent personal contact with a client and with his associates or dependents. We do not publish for general distribution a statistical service or compendium of general economic observations or financial recommendations. To use a hackneyed phrase, our business is "tailor-made."

Whatever may be the merits of a plan to regulate the activities of the tipsters and others on the fringe, it seems to us that what they do is so different from what we do, in principle, in purpose, and in method, that they constitute a separate category in which we should not be involved merely because we also give financial advice. The whole effort of our business life has been to offer a service which, because it avoided the superficialities and instability characteristic of the tipster service and related enterprises, could establish for itself an enduring professional reputation.

However, we would not have the committee believe that we think we should be immune from regulation merely because we conduct a business which is different from that of others who are or perhaps should be regulated. Our case for believing that the business we conduct does not need to be regulated in the manner provided by the proposed legislation, rests on other grounds. We and our profession have a good record for honest dealing with the public and with our clients. We have gone to great lengths to protect our clients from a wider range of abuses than could possibly be covered by law. We do not claim unique virtues for the profession. We do not claim exemption from the supervision which "ordinary mortals" must endure. The outstanding fact of the investment counsel profession is that unless it can demonstrate that it possesses these virtues, it will pass out of existence in the long run for the most cogent of all reasons—it will be worthless.

Thus, from a selfish standpoint alone, we have the best of reasons for exercising a high degree of self-discipline. We have established and have published codes of professional practice. The profession has bound itself to policy-standards to protect its clients and the public. In many instances it has voluntarily assumed strict limitation of the right of its principals and employees to buy and sell securities in the normal way if there is any chance at all that to do so might seem to operate against the interests of clients and the public. This we have done because the success of the procession depends upon the success with which we establish in the minds of our clients and with the public in general the conviction that we are able, conscientious, honest, and impartial. Legislation of the sort proposed would weaken the initiative which now encourages these self-disciplinary efforts. They would no longer bring us the reward of an unqualified reputation for fair and honest dealings which now leads us to make them. Under the bill, only a long record of freedom from governmental action against us

could bring the same reward, and then only in the negative sense. The "honor system" breaks down under supervision which implies that it is ineffective.

The professional character of the investment counsel business results in the fact that our greatest asset, namely, reputation and public confidence, is an asset very easily destroyed by inadvertent acts. A kilowatt of electricity produced by one kind of management is just like a kilowatt produced by another kind: Not so with the advice given by investment counselors. Any event which harms our reputation, therefore, will destroy our principal asset and be tantamount to a confiscation of plant in the industrial field. The legislation now under consideration by this committee gives great power to the Securities and Exchange Commission and could easily result in the Commission unintentionally destroying our reputation and the public's confidence in us. The mere knowledge that a firm in the investment counsel business had been presented with a show-cause order issued by the Commission would raise serious doubts in the public mind as to the firm's probity and integrity, even though it were subsequently proved that there were no grounds for action against the firm or, in fact, no real reason for the order having been issued.

We do not know all of the facts available to the committee about the demand which has been made for inclusion of our profession under legislation of the character proposed. As far as we have been able to determine from our own resources, there is little serious public demand for such action. This squares with the fact that there is little or no record of abuses established against our profession. It is not in the public interest to establish supervision and regulation of a profession which is so peculiarly vulnerable to the incidental effects of contact with the regulatory and supervisory process. We think this last point bears closer examination.

Other organizations can be subjected to supervision and regulation without loss of more than reputation for the time being. If it subsequently proves that the investigation was needless, the loss of reputation can be restored on a public showing that the profession or company was guiltless. In our case, an examination, however well intentioned, of the foundations upon which our clients' and public confidence in us rests can, and we believe would, result in our loss not only of reputation but of our clientele as well. When our problem is viewed in this light, it will doubtless be clear to the committee why we regard the prospects raised by the proposed legislation with grave concern.

Regulation of this profession by the Securities and Exchange Commission is not necessary for the protection of small, uniformed investors, since they do not use investment counsel service. There is a marked difference between the owners of investment trust securities and our clients. While investment trusts sell securities in amounts sufficiently small so that even the poorest may buy, our services are designed for and limited to a group of persons who are a minority in the community. We do not deal with the general public. Our clients represent substantial amounts of capital and have adequate means to inform themselves about us through their banking and legal affiliations. They make careful investigations of the ability and integrity of investment advisers before employing them.

A principal advantage of our service to our clients is that it is confidential as against all third parties. Were this bill in force, many of

our clients would undoubtedly consider that one of the chief advantages of investment counsel service to them had been destroyed. It is against the public interest to destroy this confidential relationship by subjecting our operations to public scrutiny through hearings and investigations.

We have shown why our profession should not be regulated. We have mentioned some of the losses and dangers which it seems to us the legislation under consideration will impose upon us by its general terms. Since we are not and do not operate or give advice to an investment trust, our concern is primarily with title II of the proposed bill. A first reading of this title by one who did not know our profession and the way it operated might leave the impression that it was mild. That is not our view; but in stating our reasons we shall not give a detailed analysis of the bill because the aspects to which we object are so broad and so implicit in all provisions of the bill that such detailed criticism would be an unnecessary duplication. In general, however, we would draw attention to the several provisions in title II or included therein by reference from title I, referring to hearings, investigations, unlawful acts and enforcement, to show that the bill gives the Commission power to do almost anything it wishes and to accomplish almost any conceivable change in our operations by means fully as effective as the threat of sentence in criminal court.

Therefore, even if we were persuaded that some legislation were necessary or desirable for our profession, which we are not, we would be forced to oppose this bill on these grounds alone.

As will be clear to the committee from our statement, we believe that the investment counsel profession is quite distinct from the investment trust business and from the business of others who give investment advice; therefore we believe that we should not be lumped with investment trusts or others when regulatory legislation for them is considered. Furthermore, we do not believe that legislation providing for the investigation, supervision, and regulation of the investment counsel profession is necessary; we believe it would be dangerous to our own business and might bring about its extinction in the long run.

We believe that the legislation is against public interest and earnestly urge that the committee drop title II from consideration. In addition, we should like to reaffirm our belief that we should be forced to take this position in the interests of our profession, even if we believed some Federal regulation was desirable, because of the broad and unqualified discretion given to the Securities and Exchange Commission to determine conditions which are vital not only to the convenience but to the very existence of our operations.

Thank you.

Senator WAGNER. Are there any questions? (No response.)

Thank you very much.

STATEMENT OF ALEXANDER STANDISH, PRESIDENT, STANDISH, RACEY & McKAY, INC., BOSTON, MASS.

Mr. STANDISH. My name is Alexander Standish. I am president of Standish, Racey & McKay, Inc., Boston, Mass.

You have just been given a rather broad and clear picture of investment counselors and what we do. I do not want to repeat in any

way, and so I am going to discuss very briefly just one point, but a point which I believe is the heart of the whole question and is the reason that I believe that this bill will practically destroy the investment counsel profession.

The relationship of investment counsel to his client is essentially a personal one involving trust and confidence. The investment counselor's sole function is to render to his client professional advice concerning the investment of his funds in a manner appropriate to that client's needs. Recommendations often cover such a broad range of subjects as life insurance, methods of systematic savings, establishment of funds for the education and well-being of children, or the preservation and management of funds after death—and they are all private affairs.

For centuries individuals have been able to consult with their doctors or their lawyers, knowing that what they say will be treated with confidence. So important is this relationship that there have been set up legal measures to maintain the inviolability of these communications.

In New England, at least, individuals believe that information as to personal savings and family financial arrangements is to be guarded as carefully as are confidences given to medical or legal advisers. We believe that it is equally important to society that persons be able to disclose and discuss their financial affairs with trusted advisers without fear that such disclosures can or will become public property.

These are not theoretical matters. We, for instance, on occasion have had to advise the establishment of irrevocable trusts for the protection of individuals incapable of managing their own affairs; in other instances legal guardianships were set up; and in one case the confidential character of our relationship permitted information reaching us of such character that a fraud was prevented without embarrassing publicity to our client and at the same time provided the Federal Bureau of Investigation with valuable evidence.

Perhaps it will be said that that these are the few and extreme examples and are not representative. Let us look at my office as a fair sample of investment counsel firms. Our work with clients is so continuous, detailed, and inclusive that we have less than five clients for each member of the firm and staff. There is nothing comparable with this in merchandising securities. The dangers arising from the revelation of confidential details of clients' affairs affect groups of clients in various ways. For example, about two-thirds of our fees come from private trustees, mutual savings banks, and mutual insurance companies. Clients of this type do not want to it be known even that they consult us. The trustees of savings banks located in small towns have the feeling that the depositors might conclude that the trustees were not capable of investing the funds whereas actually our work is merely to assist them in carrying out their fiduciary obligations. Another group of clients is made up of business men who feel it necessary to tell us the intimate details and risks of their own business in order that we can compensate for these risks by increasing the conservatism of their own personal investments. If information given to us in this connection should become known to our clients' competitors it might result in serious damage to a client's business. Many of our clients are elderly people and the manner in which they intend to bequeath their money at death has a very important bearing on their current investments. The revela-

tion of their intentions in respect to their wills obviously could produce a great deal of trouble within families. In some instances individuals and organizations of national importance have asked us to make studies of special problems and had it become known even that such a study was being made the repercussions would have been important and definitely contrary to the client's interest.

We regard this confidential relationship as so vital that we have set up many safeguards within our own organization. Thus the records of our clients' accounts are maintained under code number so that only a few of the members of our staff know the names of the clients on whose problems they may be working. We have an absolute rule that even the mention of a client's name outside of the office means immediate dismissal. Even the physical lay-out of our office is such that every member of the firm who discusses problems with clients has a completely private office and the telephone system is so arranged that no one in our office can listen to conversations between a client and his adviser. This true professional relationship that exists between counsel and client is the very foundation of our work. There seems to be no sound reason that the public should be denied the right to go to trusted counsel and discuss their private affairs without any fear that what they say would become known to anyone.

Our principal objection to the proposed Investment Advisers Act of 1940 is that if it becomes law we can be compelled to disclose the confidential communications of our clients. We may be compelled to make this disclosure as a condition precedent to registration. We may be compelled to disclose it if the Securities and Exchange Commission decide to gather information for the purpose of future legislation or to prescribe its rules and regulations. We may be compelled to disclose it in any investigation by the Securities and Exchange Commission for a violation of law in advance of any finding of guilt, or a suspicion that we are about to violate the law.

We believe that it is not in the public interest to publish the financial affairs and private communications of our clients but rather that the public interest demands that these confidences be protected, at least so far as they now are by law.

If the Committee feels that some form of regulation of investment counsel is essential in the public interest, then we would respectfully urge that rather than adopt a law which strips the public of its right to private counsel it should provide a law that prohibits any counselor under any conditions from revealing any information concerning any of his clients.

It may be said that this is not another "pink slip" law and that it is not the intention of the Securities and Exchange Commission to make public the personal affairs of such of the public as seek the advice of investment counsel. This is not a pertinent assertion. The mere existence of such power would tend to prevent investors from revealing factors of primary importance and would destroy at once any professional relationship and would undermine the whole foundation upon which a profession such as ours is built. In fact, the publicity already given to this proposed law has led to concerned inquiries from several of our clients as to whether their private affairs would be subject to public hearings and discussion.

We can only tell them, in all honesty, that if the proposed legislation becomes law we cannot guarantee privacy as to their affairs.

If they regard such privacy as important—and they do—they must seek sanctuary by putting their financial affairs in the hands of some legal firm or other group which receives special privilege under the act.

They will have to do this even though it means accepting investment advice from those whose primary interests are elsewhere, who lack research facilities, and who are not specially trained for this work. Such a dilemma is presumably not intended by the members of the Securities and Exchange Commission who have stated that there is no intention to use this power except in instances in which fraud is suspected. Nevertheless this power is granted without qualification or limitation under the proposed statute, and the fact that such power exists is all that is necessary to destroy the confidential relationship between client and counsel. If you destroy the foundation you also destroy the profession. Perhaps the present personnel will not use this power, but obviously it is dangerous to give such great power to a future personnel appointed by unknown administrations. The history of legislation in this country indicates clearly that powers once obtained by a governmental bureau are seldom relinquished.

In order that there may be no doubt in the minds of the committee that the statute does create clearly the powers mentioned above, it is well to examine some of the specific provisions of the act [reading]:

SEC. 204 (c). Any investment adviser, or any person who presently contemplates becoming an investment adviser, may register under this section by filing with the Commission an application for registration. Such application shall contain such of the following information and documents, in such form and detail, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors:

(1) information in respect of—

* * * * * * *

(c) the nature and scope of the business of, and of the advice, analyses, and reports furnished by, such investment adviser:

(3) such further information and copies of such further documents relating to such investment adviser, his or its affiliated persons and employees, as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors.

We wish to point out that these provisions empower the Commission to require as a part of the registration statement any information and any documents of any character requested by it. This registration statement is a public document. The broad general authority to require further and unlimited information constitutes an unfettered discretionary power which is dangerous to confer on any administrative body.

The proposed act, moreover, goes much further in giving power to the Commission, by incorporating in title II numerous sections or paragraphs of title I, among which is section 38 which provides:

SEC. 38 (a). The Commission, in its discretion, may investigate any facts, conditions, practices, or matters which it may deem necessary or appropriate to determine whether any person has violated or is about to violate any provision of this title or any rule or regulations thereunder, or to aid in the enforcement of the provisions of this title, in the prescribing of rules and regulations thereunder, or in obtaining information to serve as a basis for recommending further legislation concerning the matters to which this title relates.

Now, Senators, that seems to me as wide open as the whole world. Also in the paragraph the bill states briefly:

The Commission may require or permit any person to file with it a statement in writing, under oath or otherwise as it shall determine, as to any or all facts and

circumstances concerning a matter which may be the subject of investigation. The Commission, in its discretion, may publish information concerning any of the foregoing matters.

There can be no doubt that this wording empowers the Commission to make any investigation that it desires, irrespective of any evidence or even any suspicion of any violation of the statute.

Section 38 (b) provides:

(b) For the purpose of any investigation or any other proceeding under this title, including any examination pursuant to section 31, any member of the Commission, or any officer thereof designated by it, is empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, contracts, agreements, or other records which are relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in the State or in any Territory or other place subject to the jurisdiction of the United States at any designated place of hearing.

There can be no doubt that under this provision we, as investment counsel, may be compelled to produce the records, correspondence, and most intimate details of our clients' accounts; and then if we decide that we are going to protect the confidences given us, we have the prospect of a $1,000 fine or 1 year in a Federal penitentiary or both. That is the provision of paragraph (c) under the same section.

Not even the privacy inherent to a private hearing is necessarily accorded to our clients, since section 37 provides:

Sec. 37. Hearings may be public and may be held before the Commission, any member or members thereof, or any officer or officers of the Commission designated by it, and appropriate records thereof shall be kept. In any proceedings before the Commission, the Commission, in accordance with such rules and regulations as it may prescribe, shall admit as a party any interested State or State agency, and may admit as a party any representative of interested security holders, or any other person whose participation in the proceeding may be in the public interest or for the protection of investors.

The language used in the bill giving these sweeping powers is perfectly definite and clear; it is useless to argue that it does not mean what it says.

In conclusion, I should like to say that our objections to the bill are many and fundamental, but they have been or will be covered adequately by the testimony of other witnesses, and I have no desire to take the committee's time in mere repetition. I should like to state, however, with all the emphasis that I can command that, in conclusion, we believe, first, that in order to give proper investment advice we must have all the facts concerning our clients' financial problems; second, all of the facts will not be given us without complete assurance that such facts will not be revealed; third, the essential nature of completely frank discussion has been recognized in the medical and legal professions; and the law has set-up legal safeguards to maintain them inviolable. Similar safeguards should be extended to the investment counsel profession; fourth, destruction of the present confidential relationship would destroy the very foundation of the profession.

One of the finest investment counselors, and one of the earliest, who if he were now living would be at this table today, said to me several years ago, "I will tell the Government anything it wants to know about our business, but I will lock the doors and cease to practice the day that anyone can require me to reveal the affairs of my clients, told me because they trusted me not to reveal them."

Gentlemen, very many of us feel that strongly on the matter.

We most earnestly urge that title II of this bill be completely eliminated; and without in any way being impertinent, we would urge that public announcement to that effect be made as soon as possible, in order to halt the damage that is being done to the profession even by these hearings.

In our opinion, and as far as true investment counsel are concerned the bill is entirely and utterly destructive.

Thank you, Mr. Chairman and Senators, for the privilege of addressing you.

Senator WAGNER. Thank you, Mr. Standish.

Mr. Dwight C. Rose will be the next witness, I believe. Please come forward, Mr. Rose.

STATEMENT OF DWIGHT C. ROSE, PARTNER OF BRUNDAGE, STORY & ROSE, NEW YORK CITY, AND PRESIDENT, INVESTMENT COUNSEL ASSOCIATION OF AMERICA

Senator WAGNER. Will you proceed, Mr. Rose?

Mr. ROSE. Mr. Chairman and Senators, my name is Dwight C. Rose. I am a general partner of the investment counsel firm of Brundage, Story & Rose, investment counsel, at 90 Broad Street, New York. I am also president of the Investment Counsel Association of America, a voluntary, nonprofit professional association, the membership of which comprises 61 individuals who are principals or associates in 18 different investment counsel firms located in various parts of the United States—firms, the sole function of which is to "render to clients, on a personal basis, competent, unbiased, and continuous advice regarding the sound management of their investments."

Senator WAGNER. Have you any idea how many counselors are outside of your organization?

Mr. ROSE. I will come to that point a little later in my statement, with your permission, Mr. Chairman; or I should be glad to answer that now, as you prefer.

Senator WAGNER. No; please go right on; I do not want to interrupt you.

Mr. ROSE. It is estimated that these 18 member firms have under their supervision funds of clients aggregating in excess of $600,000,000.

I am making my statement as president of the Investment Counsel Association, and I ask your permission to read it as it has been approved by the association's executive committee.

At the outset may I assure you, without reservation, that the members of the association, and all other investment counsel with whom I have come in contact, are most desirous of keeping the profession free from all forms of abuse. Maintenance of high standards of integrity, competence, and practice is dictated by our self-interest; for in the long run we can prosper only if the investment counsel profession maintains a reputation for honesty, for ability, and for sound methods of practice. Therefore, we strongly favor whatever method may be relied upon to assure this desirable result.

It was recognition of the need for cooperative effort to bring this assurance into the field which prompted a number of investment

counsel firms a few years ago to join in an effort to maintain and improve the standards of this young profession—an effort, if you please in self-regulation. In view of this effort, now well under way, may I give you a brief history of the profession, and of the Investment Counsel Association of America, in order that you may judge the merits and the possibilities of self-regulation? Then I shall discuss the proposal for Federal legislation and regulation.

I should like first to take up the question of the origin and function of investment counsel. These matters were discussed at hearings before the Securities and Exchange Commission, at Washington, in February 1938. A stenographic transcription of these hearings has been reproduced in the 1938 Investment Counsel Annual, several copies of which I have brought along for your information; and I shall be glad to leave them with you before I go.

The rise of investment counsel in the early 1920's was occasioned partly by certain weaknesses in our investment banking system and partly by the increased complexity in the financial structure and operation of companies. A growing recognition by the investor of his difficulty in obtaining, under such conditions, competent and unbiased guidance in the management of his investments has caused a rapidly increasing demand for investment counsel services.

The two fundamental principles upon which the pioneers in this new profession undertook to meet the growing need for unbiased investment information and guidance were, first, that they would limit their efforts and activities to the study of investment problems from the investor's standpoint, not engaging in any other activity, such as security selling or brokerage, which might directly or indirectly bias their investment judgment; and, second, that their remuneration for this work would consist solely of definite, professional fees fully disclosed in advance.

The name "investment counsel," not then in use, was selected to describe both the work based on these two principles, and the persons engaged in that work.

Generally speaking, those engaged in strictly investment counsel work have conducted their activities in accordance with the highest ethical principles—partly, perhaps, because the investors with funds large enough to warrant retaining investment counsel have possessed sufficient intelligence and investment sophistication to select their investment counsel prudently. Also, it has been fortunate that the pioneers in the field were men of high ideals, willing to undergo a long period of hard sledding, and not a little ridicule within the financial community, in order to stand steadfastly by the fundamental principles upon which they had embarked.

From very small beginnings in the early 1920's, this function of rendering to clients—on a personal, professional basis—competent, unbiased, and continuous advice regarding the sound management of their investments, has had a steady growth. That growth has been reflected both in the amount and number of funds supervised and in the size and number of firms and individuals engaged in the practice. The success of the men who developed and adhered to the two fundamental principles of investment counsel resulted, before long, in the

inauguration of so-called "investment counsel" departments by investment dealers, brokers, a few banks, and by others who did not adhere to these two basic principles; but they used the name. Then, too, a few outright exploiters may have found the respectability of the investment counsel title an effective shield under which to conduct unethical and even fraudulent practices; but the young profession, until recently, has been unorganized and too weak to confine the use of its chosen name to the original meaning, or to warn the public of its misuse.

By 1934, many of the strictly investment counsel firms had come to recognize some of the common problems of the profession and began holding conferences with a veiw to forming an association for the formulation and advancement of standards and for the education of the public. Early in 1937, the Investment Counsel Association of America was formally organized by a number of such firms.

For your examination I shall later submit copies of three printed résumés of proceedings incident to the organization of the Investment Counsel Association in May 1937. To give you a general picture of the reasons for the organization of this association, I cannot do better than to read one or two paragraphs from these printed résumés of these proceedings.

I quote:

> If an association is organized it should first be limited to those pioneers in the profession whose conduct and present methods of procedure have gradually evolved from an unqualified interest in serving the investors' welfare. Where executives of such firms have become personally known one to another and their common interest in serving the investors' welfare has led to a common ground for ethical conduct and procedure, we have the basic qualifications necessary for the original nucleus about which a sound investment counsel association may be developed.
>
> It was agreed that the proposed Association should not be exploited for business-getting purposes, and that any publicity sponsored by the association should not advertise the names of member firms. It was further agreed that no general publicity should be given to the initial formation or to the activities of the proposed association until a suitable constitution and code of professional practice had been carefully worked out, adopted, and had stood the test of practical operation by and among the original membership.

That ends the quotation from these proceedings, of which I will give you a copy.

Since the organization of this association, our work has been confined primarily to the following:

First, the development of a code of professional practice to which all members of the association and the majority of recognized practitioners outside of the association, appeared willing to subscribe; and the development of a constitution to implement this code, to provide for the disciplinary action of members found in violation of it, and to govern the Association's organization and activities.

Copies of the constitution and code of professional practice, revised to January 22, 1940, are available for your later inspection and will be left with you. The code of professional practice is fairly short—a great deal of time and effort has been spent in developing it; and, with your permission, I should like to read it to you at this point [reading]:

INVESTMENT COUNSEL ASSOCIATION OF AMERICA

CODE OF PROFESSIONAL PRACTICE

Whereas the profession of investment counsel came into being to meet a growing need for a type of competent and unprejudiced services not otherwise rendered; and

Whereas experience in the rendering of investment counsel services has established certain basic principles of responsibility and conduct requisite to sound professional practice; and

Whereas these basic principles must be accepted and maintained if the investing public is to be assured of the standard of investment counsel services to which it is entitled;

Now, therefore, we, the subscribers to this Code of Professional Practice, do declare the following principles to guide all those who profess to render investment counsel services; do pledge ourselves and our organizations to adhere to these principles; and do agree, through proper articles of association, to enforce such adherence by all subscribing members.

The first principle is contained under the heading, "Definition and Limitation of Functions":

It is the function of the profession of investment counsel to render to clients, on a personal basis, competent, unbiased and continuous advice regarding the sound management of their investments. An investment counsel firm should devote its time exclusively to the performance of this function and services incidental thereto; it should not engage in the business of security merchandising, brokerage, banking, the publication of financial services, or acting as custodian of the securities or funds of clients; and neither the firm nor any partner, executive or employee thereof should directly or indirectly engage in any activity which may jeopardize the firm's ability to render unbiased investment advice.

The second title is, "Competence and Responsibility":

To serve its clientele effectively and continuously an investment counsel firm should preferably include at least two responsible partners or principal executives of demonstrated investment ability and unquestioned integrity; it should be supported by a competent staff of experienced assistants; and it should maintain adequate capital and reserves at all times.

On the matter of "Compensation for Services":

Compensation of an investment counsel firm should consist exclusively of direct charges to clients for services rendered, and should not be contingent upon profits, upon the number or value of transactions executed, nor upon the maintenance of any minimum income.

On the matter of "Solicitation of New Clients":

The methods employed and all written and oral statements made by an investment counsel firm in securing new clients should conform to standards consistent with the professional nature of investment counsel services.

On the matter of "Confidential Relationship":

All information concerning the security holdings and financial circumstances of clients should be held in strict confidence by the firm and its personnel.

That completes our code.

Another matter undertaken by the association is in connection with the determination of the detailed information to be required of applicants to pass upon their qualifications and suitability for membership. This subject has represented a considerable amount of serious thought and careful testing over the past 3 years. These requirements are indicated on this application for membership form, copies of which are now submitted.

The form of application for membership, of the Investment Counsel Association of America, is as follows:

[Confidential]

INVESTMENT COUNSEL ASSOCIATION OF AMERICA

PART I. APPLICATION FOR MEMBERSHIP

(Date) ______________________________

Note: This applica'ion should be accompanied by letters from three members of the Association attesting to applicant's general character and investment capabilities.

I hereby apply for membership in the Investment Counsel Association of America and submit the following information for the confidential use of the Association in passing upon this application. If I am accepted for membership, the information included herein becomes the permanent record and property of the Association; if I am not accepted for membership, this application is to be returned to me upon request.

1. Name of Applicant: ______________________________ Age: ________
   Address: Office: ______________________ Telephone: ________________
   Residence: ______________________ Telephone: ________________
2. Schools, Colleges, and Universities attended:

Names of Institutions	*Periods Attended*	*Degrees Received*
________________	________________	________________

3. Club and Association Memberships:
   ____
4. Published writings, articles, books, etc., bearing on any phase of economics, finance, or investments:
   ______________________________ ______________________________
5. (a) Former Business Affiliations:

Period of Affiliation	*Name and Address of Organization*	*Nature of Business*	*Position Held*
________________	____________________	____________	__________
	____________________		

   (b) Present Business Affiliations:

Period of Affiliation	*Name and Address of Organization*	*Nature of Business*	*Position Held*
________________	____________________	____________	__________
	____________________		

(Signature of Applicant) ______________________________

(*Additional information that may aid the Membership Committee in determining applicant's qualifications for membership may be offered in a letter addressed to the Membership Committee and enclosed with this application.*)

[Confidential]

INVESTMENT COUNSEL ASSOCIATION OF AMERICA

PART II. INFORMATION REQUIRED CONCERNING THE FIRM OF APPLICANT

(*"Firm" as used herein means either a partnership or a corporation*)

(Date) ______________________________

In connection with the applications for membership in the Investment Counsel Association of America of the undersigned partners or principal officers of the firm of ____, we submit the following information concerning our firm for the confidential use of the Association in passing upon our applications. If any of the undersigned are accepted for membership, the information included herein becomes the permanent record and property of the Association; if none of the undersigned are accepted for membership, this application is to be returned upon request.

1. Name of Investment Counsel Firm ______________________________
   Address of Main Office ______________________________________
   Addresses of branches or affiliated offices:
   ______________________________ ______________________________
2. Form of Organization (Partnership or Corporation): ________________
3. (*a*) Date of Organization: ______________________________
   (*b*) Place of Organization: ______________________________

4. If the name of the firm has been changed since date of organization, furnish each former name and date of each change of name:

Former Name	*Date of Change*

5. If the firm is the successor by purchase, merger, consolidation, or otherwise, of any other organization furnish in chronological order the date of each succession and the name and last address of each predecessor:

Name and Address of Predecessor	*Date of Succession*

6. If the firm is a corporation:
(*a*) State the total amount of stock authorized and outstanding:

(*b*) Furnish the name and address of (1) each officer, (2) each director, and (3) each stockholder owning 10% or more of any class of the stock of the corporation, together with a statement of the number of shares held by each at the date of this application:

Name and Address	*Officer, Director or Stockholder*	*Number of Shares Owned*

7. If the firm is a partnership, furnish the name and address of each partner, designating whether special, limited or full partner and give the percentage ownership of each:

Name and Address	*Special, Limited or Full Partner*	*Percentage Ownership*

8. (*a*) The total number of full-time personnel of the firm is (including partners and officers): ______
(*b*) The number of full-time personnel primarily engaged in new business development is: ______
9. (*a*) The total part-time personnel of the firm is (including partners and officers): ______
(*b*) The number of part-time personnel primarily engaged in new business development is: ______
10. (*a*) If, during the past five years, the firm has engaged in the business of security merchandising, brokerage, banking, or the publication of financial services, or acted as custodian of the securities or funds of clients, or engaged in any business other than that of furnishing investment counsel or investment management services, briefly describe the nature of such other business or businesses:

Nature of Other Business	*Period Engaged*

(*b*) If, during the past five years, the firm has been connected or affiliated with or was part of any other organization, furnish the name and address of each other organization and a brief description of the business of each such other organization:

Name and Business of Affiliated Organization	*Period of Affiliation*

11. (*a*) Has the firm at any time during the past five years advertised its investment counsel services in newspapers or other periodicals? ______ If so, enclose copy of each such advertisement.
(*b*) Enclose copies of any booklets or other literature used in explanation of or development of the investment counsel services of your firm.
12. (*a*) Has the firm at any time during the past five years managed, supervised, or furnished investment advice to any common or commingled fund? (Yes or No) ______
(*b*) If answer is "Yes," briefly describe present relationship to such common or commingled fund.

---

13. (a) Has the firm at any time during the past five years managed or supervised the portfolio or security account of, or furnished investment advice to, any investment trust or investment company? (Yes or No) ______
(b) If answer is "Yes," briefly describe present relationship to any such investment trust or investment company.

---

14. Current gross fees from clientele of the firm are divided as follows:

	% Total
1. Individuals and Trustees----------------------------	------------
2. Commingled or Mutual Investment Funds--------------	------------
3. Investment Trusts or Companies----------------------	------------
4. Banks--	------------
5. Insurance Companies and Charitable Organizations------	------------
6. Industrial, Railroad, and Public Utility Corporations----	------------

15. What percentage of the number of clients retaining your firm on—
    December 31, 19----, is retaining your firm today? ------%
    December 31, 19----, is retaining your firm today? ------%
    December 31, 19----, is retaining your firm today? ------%
    December 31, 19----, is retaining your firm today? ------%
    December 31, 19----, is retaining your firm today? ------%
    (Use the past five calendar years.)

16. What percentage of the total fees (exceeding $250 per annum) received in each of the past five calendar years came from accounts retaining your firm on ---------------- ------, 19----? (Fill in your most convenient recent date.)
    19---- ------% 19---- ------% 19---- ------% 19---- ------%
    19---- ------%

17. (a) What is your regular basis of compensation for services? ---------------
    ----

    (b) What percentage of total fees received during the past year were for special consulting services, or were not assessed in accordance with the general plan outlined in (a)? ------%
    (c) If, during the past twelve months, the firm received any compensation from clients contingent upon profits or based on the number or value of transactions executed or the maintenance of a minimum income, outline each such instance briefly: --
    ----

18. (a) Do you have written contracts with clients? ---------- If so, attach form of contract used.
    (b) If you do not have written contracts with clients, explain nature and form of agreement with clients, including the minimum period for which it is understood your services will be retained. ----------------------------
    ----

19. What are your usual fee periods for billing purposes? (Annual, Semi-Annual, Quarterly, or Monthly.) ----------------

20. Are clients billed prior to or at the expiration of fee periods? ------------

21. Is the firm's accounting set-up on a cash or on an accrual basis? ---------

22. (a) What percentage did the cash and good accounts receivable of the firm bear to the firm's total liabilities, including fees prepaid by clients, at the most recent accounting period as of ----------------- 19----? ------%
    (b) If marketable securities were owned by the firm, what percentage did such marketable securities, computed at market, bear to the firm's total liabilities, including fees prepaid by clients, at the most recent accounting period as of -------- ----, 19----? ------%

23. (a) What percentage has the firm's average monthly cash balance borne to its total annual operating expenses (excluding drawings of partners or salaries paid to principal officers) during the past twelve months? ------ %
    (b) If marketable securities were owned by the firm, what percentage has the average monthly market value of such securities borne to the firm's total annual operating expenses (excluding drawings of partners or salaries paid to principal officers) during the past twelve months? ------%

24. Is it the policy of your firm at any time to approve or recommend borrowing by clients for the purpose of carrying securities supervised or managed by your firm? ------ (Yes or No.)
    If answer is "Yes," please give full explanation of circumstances under which such borrowings may be approved or recommended: --------------------
    ----

25. Does your firm accept responsibility for placing orders direct for clients with or without powers of attorney? ---------- If so, attach copy of agreement or letter used to obtain such authority.

26. What percentage of total fees represent accounts for which purchase and sale orders are placed directly by your firm? ______%
27. (a) Can you subscribe without reservation to the Code of Professional Practice of the Investment Counsel Association of America enclosed with this application? (Yes or No) ______
(b) If you have any reservations, please explain fully.

____

Signed: ____________________________ ____________________________

(*Additional information to supplement the answers included in this application may be offered in a letter addressed to the Membership Committee by the signatories to this application and attached hereto.*)

Agreement Entered Into Upon Admission to Membership in the Investment Counsel Association of America

Having been duly elected a member of the Investment Counsel Association of America, I hereby make the agreements hereinafter set forth, the execution of which by me is a condition precedent to my admission as a member of the Association.

I hereby agree that my membership in the Investment Counsel Association of America, and its continuation, shall be subject to all of the provisions of the Constitution and Code of Professional Practice of the Association, including any amendments thereto.

I further and expressly agree for the duration of my membership in the Investment Counsel Association of America to accept and abide by any and all decisions of the Committee on Professional Conduct and of the Board of Governors, with respect to the duration of my membership in the Association, made in pursuance of the authority conferred upon said Committees by the Constitution and Code of Professional Practice, however said Committees may from time to time be constituted.

I further agree that, in consideration of my admission to membership in the Investment Counsel Association of America, I expressly waive any claims against the Association or any of its members, which I may hereafter have, either in law or in equity, arising out of any suspension or termination of my membership in the Association by the Board of Governors or the Committee on Professional Conduct, or of any proceedings in connection therewith, or arising out of any suspension or termination of the privilege accorded to any partnership or corporation, with which I may be connected, to describe itself as "Members Investment Counsel Association of America," by virtue of my membership therein.

The foregoing agreement is entered into in my own behalf and likewise in behalf of the partnership or corporation with which I am connected; and I further state that I have the authority of such partnership or corporation to enter into such agreement in its behalf.

Dated: ____________________, 193__

____
(Name)

____
(Address)

Partner or Principal Office in:
(Cross out words not applicable)

____
(Name of partnership or corporation)

____
(Address)

Code of Professional Practice and Agreement of Adherence Thereto by Candidates for Membership, August 1937

CODE OF PROFESSIONAL PRACTICE ADOPTED BY THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA

Whereas the profession of investment counsel came into being to meet a growing need for a type of competent and unprejudiced services not otherwise rendered; and

WHEREAS experience in the rendering of investment counsel services has established certain basic principles of responsibility and conduct requisite to sound professional practice; and

WHEREAS these basic principles must be accepted and maintained if the investing public is to be assured of the standard of investment counsel services to which it is entitled;

NOW, THEREFORE, WE, the subscribers to this Code of Professional Practice,

DO DECLARE the following principles to guide all those who profess to render investment counsel services;

DO PLEDGE ourselves and our organizations to adhere to these principles; and

DO AGREE, through proper Articles of Association, to enforce such adherence by all subscribing members:

I. Definition and limitation of functions

It is the function of the profession of investment counsel to render to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments. An investment counsel firm should devote its time exclusively to the performance of this function and services incidental thereto; it should not engage in the business of security merchandising, brokerage, banking, the publication of financial services, or acting as custodian of the securities or funds of clients; and neither the firm nor any partner, executive, or employee thereof should directly or indirectly engage in any activity which may jeopardize the firm's ability to render unbiased investment advice.

II. Competence and responsibility

To serve its clientele effectively and continusously an investment counsel firm should include at least two responsible partners or principal executives of demonstrated investment ability and unquestioned integrity; it should be supported by a competent staff of experienced assistants; and it should maintain adequate capital and reserves at all times.

III. Compensation for services

Compensation of an investment counsel firm should consist exclusively of direct charges to clients for services rendered, and should not be contingent upon profits, upon the number or value of transactions executed, nor upon the maintenance of any minimum income.

IV. Solicitation of new clients

The methods employed, and all written or oral statements made, by an investment counsel firm in securing new clients should conform to standards consistent with the professional nature of investment counsel services.

V. Confidential relationship

All information concerning the security holdings and financial circumstances of clients should be held in strict confidence by the firm and its personnel.

AGREEMENT OF ADHERENCE TO CODE OF PROFESSIONAL PRACTICE BY CANDIDATES FOR MEMBERSHIP IN THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA

I hereby subscribe, and agree to be responsible for the strict adherence by the partnership or corporation with which I am connected, to the foregoing Code of Professional Practice.

Dated: ______________________, 193__

____
Name

____
Address

Partner of Principal Officer in:
(Cross out words not applicable)

____
Name of partnership or corporation

____
Address

Code of Professional Practice and Agreement of Adherence Thereto by Non-Member Executives and Employees, August 1937

CODE OF PROFESSIONAL PRACTICE ADOPTED BY THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA

WHEREAS, the profession of investment counsel came into being to meet a growing need for a type of competent and unprejudiced services not otherwise rendered; and

WHEREAS, experience in the rendering of investment counsel services has established certain basic principles of responsibility and conduct requisite to sound professional practice; and

WHEREAS, these basic principles must be accepted and maintained if the investing public is to be assured of the standard of investment counsel services to which it is entitled;

NOW, THEREFORE, WE, the subscribers to this Code of Professional Practice,

DO DECLARE the following principles to guide all those who profess to render investment counsel services;

DO PLEDGE ourselves and our organizations to adhere to these principles; and

DO AGREE, through proper Articles of Association, to enforce such adherence by all subscribing members:

I. Definition and limitation of functions

It is the function of the profession of investment counsel to render to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments. An investment counsel firm should devote its time exclusively to the performance of this function and services incidental thereto; it should not engage in the business of security merchandising, brokerage, banking, the publication of financial services, or acting as custodian of the securities or funds of clients; and neither the firm nor any partner, executive or employee thereof should directly or indirectly engage in any activity which may jeopardize the firm's ability to render unbiased investment advice.

II. Competence and responsibility

To serve its clientele effectively and continuously an investment counsel firm should include at least two responsible partners or principal executives of demonstrated investment ability and unquestioned integrity; it should be supported by a competent staff of experienced assistants; and it should maintain adequate capital and reserves at all times.

III. Compensation for services

Compensation of an investment counsel firm should consist exclusively of direct charges to clients for services rendered, and should not be contingent upon profits, upon the number or value of transactions executed, nor upon the maintenance of any minimum income.

IV. Solicitation of new clients

The methods employed, and all written or oral statements made, by an investment counsel firm in securing new clients should conform to standards consistent with the professional nature of investment counsel services.

V. Confidential relationship

All information concerning the security holdings and financial circumstances of clients should be held in strict confidence by the firm and its personnel.

(NOTE.—The above Code is signed by all members of the Investment Counsel Association of America as a condition precedent to membership therein.)

AGREEMENT OF ADHERENCE TO CODE OF PROFESSIONAL PRACTICE BY EXECUTIVES AND EMPLOYEES OF MEMBER FIRMS OF THE INVESTMENT COUNSEL ASSOCIATION OF AMERICA

Recognizing the professional character of the relationship between investment counsel and clients and the fundamental requirement of an unprejudiced approach

to their problems; and being aware of the jeopardy in which the interests of the firm and its clients may be placed through any violation by me of the principles set forth in the Code of Professional Practice of the Investment Counsel Association of America, which I have read with care, I hereby agree that so long as I continue to be associated with the firm of__________________________________ and such firm is entitled to describe itself as "Members Investment Counsel Association of America," I shall adhere strictly to all of the provisions set forth in this Code of Professional Practice.

This agreement embodying the Code of Professional Practice of the Investment Counsel Association of America is being executed in triplicate, one copy to be forwarded to the Secretary of the Investment Counsel Association of America, one copy to be retained by the firm of______________________________________ and one copy to be retained by me.

(Signed)__________________________________
Employee

Approved by__________________________________
Partner or principal officer

Dated:____________________________, 193__

Mr. ROSE. I should like to pass out to you gentlemen copies of these forms, at this time, if I may; and I should be glad to comment upon them. I shall not burden you by going through it in detail.

Senator WAGNER. Do you inquire of the man's past, at all?

Mr. ROSE. We do, sir.

First, you see, this is divided into two parts.

Senator WAGNER. I see.

Mr. ROSE. All of this information on the first page of part 1 refers to the name of the applicant, his background, his club and association memberships, his published writings, articles, books, and so forth.

On the back of that page you see we require all of his former business affiliations and all of his present affiliations.

However, the major part of the application is contained in part 2, which requires information concerning the firm of the applicant; and, of course, it also applies to the individual partners of the firm.

Senator WAGNER. I was just wondering how far you went into his past. You ask about his business; and I suppose that would include whether in the past he had been in difficulty?

Mr. ROSE. Of course, Mr. Chairman, we know you can never find out much about character by a questionnaire.

Senator WAGNER. No; except if he has ever been convicted of a crime, that might mean something, don't you think so?

Mr. ROSE. Do you mean to ask him the question?

Senator WAGNER. Yes.

Mr. ROSE. We believe we go into the matter much more thoroughly.

Senator WAGNER. You think you can get that, anyway?

Mr. ROSE. We think we go much beyond that.

Senator WAGNER. Yes. All right.

Mr. ROSE. The first part of this is concerned with the history of the firm. I shall not go into the details here. It is the usual sort of information.

Senator WAGNER. Yes; I see it is a quite detailed inquiry.

Mr. ROSE. I think you will find it is, sir.

Item 6: If the firm is a corporation, it is required to state the total amount of stock authorized and outstanding; and under (*b*) it is required to furnish the name and address of each officer, each director, and each stockholder owning 10 percent or more of any class of the

stock of the corporation, together with a statement of the number of shares held by each at the date of the application.

Item 7: If the firm is a partnership, they are required to furnish the name and address of each partner, designating whether of special, limited, or full partner, and giving the percentage ownership of each; in other words, the full ownership.

Senator WAGNER. I think you need not go into it any further, but the committee will go into it fully; you can rely on that. It is a very careful committee.

Mr. ROSE. Of course.

I should like to refer specially to items 15 and 16, with respect to the percentage of the number of clients retained by the firm on different dates. That has been the most effective means we have yet discovered of determining whether or not an investment counsel firm has been conducting its affairs in the public interest. If the clients of that firm stay with that firm over a period of 5 years, that is the best indication we have.

Furthermore, since each firm is required to answer this questionnaire annually, and if any new development comes into the picture, the minute a firm begins to lose clients, we will become curious. That is the best indication we have had with respect to whether or not something may be wrong with the firm.

Of course, the fact that a firm did lose clients would not necessarily mean that something was wrong; but it would make us suspicious.

A special committee for the study of investment counsel qualifications, consisting of six members and including three qualified men not engaged in the practice of investment counsel, was appointed by the association in January 1939, to investigate and report its recommendations with respect to: first, the specific nature of the "technical training and practical investment experience" which should be required for eligibility to membership in the association; second, the "information" specifically to be "required regarding the applicant's firm" in order that his eligibility might be determined; third, the character of "oral and written examinations to demonstrate competence" of applicants; fourth, whether any further requirements in the public interest should be added to those already imposed; and fifth, a feasible plan whereby the recommendations of this special committee might be satisfactorily adjusted to the gradual evolution of the profession.

The members of this committee not engaged in the practice of investment counsel were Ernest Angell, former regional administrator of the Securities and Exchange Commission at New York; Rudolf P. Berle, of the law firm of Berle & Berle; and Ordway Tead, chairman of the Board of Higher Education of New York.

After considerable investigation and study of the problem, this special committee's report, consisting of some 47 pages, was submitted to the Board of Governors under date of July 31, 1939. The Board of Governors was in unanimous agreement with the general findings and recommendations contained in this thoroughgoing and valuable report. Some of the recommendations have already been adopted and the others are under consideration. I shall, a little later, comment on one or two of these recommendations; and I shall leave copies of that report with you.

Another step in the work of the committee has been in connection with a general plan of public education which has been embarked upon, which up to the present time has been relatively limited in scope of operations. This plan has, however, embraced the distribution of approximately 60,000 copies of the code of professional practice, which I have read to you, to banks, investment dealers and brokers, business schools and colleges, better business bureaus, State and Federal Government officials, financial writers, and investors.

It has included a distribution of approximately 7,800 copies of the 1938 and 1939 Investment Counsel Annuals, which publications contain such articles as Some Potential Responsibilities of the Investment Counsel Profession, by Ernest Angell; A Persistent Delusion, which is a 34 page thesis to demonstrate the futility of "stock market guessing," by Henry W. Dunn, professor of finance at Harvard University; The Function of Investment Counsel in a Changing Economy, by David Friday, president of the National Bureau of Economic Research; and a comparative study of Stock Ownership by Managements of Leading United States Corporations, by Brevoort Stout. As I previously told you, the 1938 Annual included a complete transcript of the public hearing of investment counsel firms before the Securities and Exchange Commission, in February 1938; and the 1939 Investment Counsel Annual contained a complete report of the special committee for the study of investment counsel qualifications

News releases have been distributed for public education on all of these articles and reports, and on many others prepared under the auspices of the association. Such educational material has in this way had a wide distribution through the newspapers.

A fifth step in our work has been this:

Either prior to or following adoption of the association's code of professional practice, every member firm included in the original membership has found it necessary to make some changes in its organization or procedure in order to comply strictly with the provisions of that code—*every firm*. The inability of one or two member firms immediately to readjust certain of their practices that appeared to be in violation of a strict and technical interpretation of the association's constitution and code of professional practice, has, at the request of such members, resulted in the convening of the board of governors as a trial board and the placing of such firms on "conditional" membership until these minor technical infractions could be corrected.

It should furthermore be pointed out that many non-member investment counsel have informed the association that they have already, or are in process of, readjusting their practices to conform with the provisions of the association's code.

The last item:

After 3 years' practical experience in operation with the nucleus of a relatively small membership, and supported by the recommendation of the special committee for the study of investment counsel qualifications, the association has recently been taking active measures to expand its membership.

The purpose in presenting to you this historical background of the Investment Counsel Association, whose membership is currently undergoing considerable expansion, is to emphasize that investment counsel, themselves, have recognized the ultimate need for some

positive agency to promote high standards of integrity and responsibility, to maintain a code of professional practice as a guide to the profession, and to educate the public to demand certain minimum standards of those from whom they are willing to accept investment advice.

You asked me a moment ago something about how many investment advisers there were.

Senator WAGNER. Sixty-one in your association. Now, how many are out?

Mr. ROSE. Yes; that is what I am going to discuss, sir.

Senator WAGNER. All right.

Mr. ROSE. Besides those which may be described as exclusively investment counsel firms, a great variety of persons is engaged in investment advisory activities. Estimates as to the number vary considerably. Most banks, trust companies, investment dealers, and brokers advise on investment problems, either as an auxiliary service without charge, or for specific charges allocated to this particular function. Many lawyers advise with respect to investment problems from time to time, and in some law firms investment advise represents a substantial part of their practice. Then, of course, the number of people who are willing to, and do, offer free advice on investment matters represents a substatial portion of the country's adult population. So it is understandable that the estimates made of the number of people engaged in investment advisory work would vary widely, depending upon just what is meant by the descriptive title of "investment counsel or adviser."

The findings of the Investment Counsel Association may shed some helpful light on this point. During the 3 years since the association has been functioning, the total number of firms and individuals, exclusive of banks, which we have been able to discover operating under the "investment counsel" or a similar investment advisory title, has been approximately 540. Some of these organizations using the descriptive title of investment counsel were in reality dealers or brokers offering to give advice free in anticipation of sales and brokerage commissions on transactions executed upon such free advice. A not inconsiderable part of this 540 would probably better be described as market forecasters, trading advisers, and a few outright "tipster bureaus"; but I judge that probably 150 to 200 of these organizations or individuals could properly be described as investment counsel serving their clients on a professional basis. Probably about one-half of that 150 or 200, however, are individuals with only a handful of clients, frequently members of their own families or close personal friends, but in most cases desirous of eventually building up a general investment counsel practice.

Who's Who in Investment Counsel, a manual recently published in New York—of which I have brought a copy along with me—and currently being distributed by Bishop's Service, one of the leading credit and character-reporting agencies in the financial field, lists 156 different organizations and individuals engaged in investment advisory work, of which slightly more than one-half are listed as engaged in "investment counsel exclusively."

I shall leave this manual with you now.

The number of people presently engaged in the giving of investment advice for remuneration, exclusive of banks and lawyers, do not con-

stitute an extensive enterprise. The strictly professional section of such advisers is undertaking self-regulation with some success. The various States, as well as the Federal Government, now have laws against fraud, which cover any serious abuses which may arise. Therefore, until further development of the profession has taken place, we believe that regulation could most effectively be left to the profession and to existing laws against fraud.

Now, Mr. Chairman, there are some inherent dangers in special Federal regulation, that I should like to bring to your attention. These dangers, particularly as contemplated in view of the bill now proposed, are: First, the restrictions which may be presently imposed and the possibility of additional future restrictions on registrants, may divert into other fields some of the more capable individuals who normally would be encouraged to prepare themselves for the practice of this new profession. We know of a number of lawyers who have given up their law practices to engage solely in the practice of investment counsel. Federal regulation from which lawyers are exempt might reverse this trend. There would also be encouragement to pursue this activity under the auspices of banks or trust companies not subject to the present bill.

A second danger is this:

Many incompetents would be permitted to register and describe themselves as "registered or licensed investment counsel." This badge of registration and apparent approval by the Federal Government might, therefore, in spite of any express provision denying such approval in the act itself, give to the unsophisticated investor a mistaken and completely undeserved impression of qualification and standing. Thus, insofar as the less intelligent investors are concerned, the very act of registration under present requirements might, at least during the earlier stages, encourage exploitation by the unscrupulous and incompetent.

A third danger:

If the powers of the Commission for investigation and regulation of investment counsel should be made relatively flexible, practitioners would be confronted with an important new consideration which might severely conflict with their clients' welfare; that is, all activities and recommendations of a cautious investment counselor would first have to be subjected to the question of whether or not at some time such activities or recommendations might involve difficulties for him in connection with the statute as enacted or with such future rulings as the Commission might make.

While this aspect of the problem may seem unimportant and academic at the present time, some idea of the potentialities may be gained by a review of the limitations under which both corporate and private trustees have for years felt it necessary to operate in order to protect their own interests from liability under existing law.

The fourth danger:

Under the regulation of a Federal commission there might, under certain conditions, be times when an investment counsel would be fearful of expressing his judgment and recommendation with respect to certain aspects of Governmental fiscal policies, general business and economic conditions, or the prospect of inflationary or deflationary developments, lest such statements might in some way be interpreted by that Federal agency as being against the public interest.

Now I come to what I think may be a most important danger:

Whether investment counsel is carried on by a group of individuals operating as a firm, or by a single individual, it must be recognized that the relationship established with clients is inherently a professional one, similar to that involved in the practice of law or accountancy. Regulation of investment counsel by a Federal commission would represent the first encroachment of the Federal government into the domain of personal, professional relationships. Therefore, I think it highly important that your committee recognize that if such a step is taken, a fundamental precedent will have been established which may be used for the further expansion of Federal regulation of individuals, to include such professions as lawyers, accountants, engineers, and others whose activities appear to be fully as much interstate in character as are those of investment counsel.

This aspect of the matter is basically so important that Mr. Berle is planning to treat it in considerable detail; and I shall not, therefore, dwell on it further at this point.

Senator Hughes. I presume it is pretty much along the same line as Mr. Andrews testified as to auditors?

Mr. Rose. Yes, sir. I wish we had a man as able as Mr. Andrews to represent us on that point.

Senator Wagner. You say Mr. Berle is going to talk about that. You were talking about lawyers. Of course, lawyers have to register. You cannot practice law unless you are registered; and you cannot practice in the United States Supreme Court, here, unless you are admitted to the bar of the United States Supreme Court.

Mr. Rose. I was referring to Federal regulation.

Senator Wagner. Well, that is regulation; because a lawyer is admitted to the bar only after examination and all that, and of course he has to register. After all, he is not regulated, except that admission to the bar qualifies him as an attorney with the right to practice; but his name is registered somewhere, so that you can always find out whether he is one who is qualified under the requirements of the statute.

I am raising these questions because I should like to get your answer: You take the case of real estate brokers—in States, of course. I think it was during the time when I was in the New York State Legislature that we enacted that law with respect to real estate brokers. Because very many unworthy persons were engaged in that business, the brokers themselves pressed for the legislation which now requires the registration of real estate brokers and also insurance brokers; and there is one other class, that escapes my mind for the moment.

Similarly there has been legislation with respect to the regulation of nurses in the practice of their profession.

Senator Hughes. And even with respect to boiler inspectors, and all down the line.

Senator Wagner. Yes.

Mr. Rose. I can assure you that the association has no desire to do anything to prevent information regarding investment counsel from going to prospective clients. My only point is that if the Federal Government undertook to establish regulation at this time, it would be going into a line which I think thus far has not been entered.

Senator Wagner. Do you think it ought to be done by the States?

Mr. ROSE. I am not sure. I think there is a trend toward more centralized Federal regulation; but I think this young profession—just about born—would not like to be used as a guinea pig to test out the idea.

Senator WAGNER. No; but I think there is a good deal of experience along the line of registration of professions which have a kinship to yours. I regard that as a very important profession, and the advice should be confidential. Nevertheless, you are certainly concerned with the question of whether or not the men in your profession are going to be men of high character; otherwise, they might very well take advantage of your clients.

Mr. ROSE. We very definitely accept that.

Senator WAGNER. And I can see that you recognize that, yourself, in your organization.

Mr. ROSE. Exactly.

Senator WAGNER. However, there are a great many whom you do not reach. What are we going to do about them? They do not come under any kind of surveillance, either by your association or by anyone else.

We are not arguing now about how much ought to be stated in that registration, because that is another question; but we are concerned with the problem of whether there should be some form of registration so that we would know who are these counselors who are engaged in this very important function. I am raising that question.

Mr. ROSE. Yes, sir.

Senator WAGNER. I have not decided it in my own mind, at all; but I am raising the question. That is why these hearings are so very helpful.

What do you say about that?

Senator HUGHES. I might suggest that there would be a considerable number who would prefer to stay outside of your association because they do not want to be brought up to these standards.

Senator WAGNER. Yes, they do not want to adhere to these high standards.

Mr. ROSE. I think we have some ideas on that; but first I should like to discuss the point you raise. It may be that you have gained the impression that the association is not desirous of having any regulation; we realize that any profession needs to have some regulation.

Senator WAGNER. Let me say that if I thought you could get all the brokers in, I—as one member of the committee—would be quite satisfied by your regulation under your own association's rules.

However, how are you going to get in the others, who may not want to live up to your high standards? Do you think mere competition will take care of that?

Mr. ROSE. I think public education will take care of that to some extent.

Senator WAGNER. It has not always done so.

Mr. ROSE. I shall discuss that later, if you do not mind, Mr. Chairman.

Senator WAGNER. Of course.

Mr. ROSE It is a very broad subject.

Senator WAGNER. I know it is.

Mr. Rose. And it is a subject of which the general public knows very little. Therefore, we are almost in a position of being accused before we put in our evidence.

If we have the complete picture of it, then I think we can discuss it more intelligently; and this matter I want to discuss now has a bearing on the subject you just raised—perhaps not at the present time, but I think it will have an increasing bearing as the profession develops.

That is this question of Federal versus voluntary self-regulation.

The increasing influence of competent and unbiased investment advice should tend to divert the flow of capital into the more productive channels, to discourage its utilization in unsound or decadent fields, and thus to diminish substantially the waste incident to financing operations stimulated largely by the sentiment or enthusiasm of an inexpert investing public. Because of this important positive function which the profession of investment counsel may perform in our national economy, it seems to me that, in the public interest, every encouragement should be given to attract into this field the most capable men available. The history of detailed governmental regulation in other fields of endeavor indicates clearly that such regulation has been a serious deterrent to the better qualified and more able men who might otherwise have entered such fields.

We believe that the growth of a positive force in the financial community, as currently represented by the better known investment counsel firms, would from a practical standpoint be more effective in promoting the welfare of our national economy than new regulatory measures burdening the field of investment and finance with unnecessary restrictions.

Certainly, it is most important that no move should be made by the Federal Government which will minimize the growth and effectiveness of voluntary regulation and self-discipline which have been undertaken by the investment counsel profession itself. In the long run, we believe that definite encouragement to such voluntary, self-regulatory agencies as the Investment Counsel Association of America would prove most constructive in the public interest; and in this connection, I should like to read one or two excerpts from the report of the special committee for the study of investment counsel qualifications—to which I referred earlier. You will remember that it is the committee including, as public members, Mr. Angell, Mr. Berle, and Mr. Ordway Tead, chairman of the Board of Higher Education of New York.

I quote from their report dated July 31, 1939, and which deals with precisely the problem you are considering:

> The Committee has given careful consideration to the possibility of suggesting some plan or method for improving the standards in the profession which might have a considerably broader application than is at this time within the province of the association to carry out. We have seriously considered the advisability of recommending registration or licensing, or even examinations under the auspices of the Securities & Exchange Commission at Washington, or by the Banking Departments or other suitable agencies in the various States.
>
> In this connection we have first had to recognize that because of the youth of the profession it would be virtually impossible to appoint a public board of sufficient experience and knowledge of investment counsel to pass upon the qualifications and competence of applicants. If licenses were issued to investment counsel on any superficial or improper examination the prestige derived therefrom by many relative incompetents would serve to discourage improvement in the standards and thus bring more harm than benefit to the public. We have, therefore, reluctantly concluded that until the qualifications and practices of the profession

have become better clarified through experience it would be inadvisable to attempt any kind of intensive legislation in the field, provided that the recognized leaders in the profession itself shall choose to use more aggressive means to educate the public to a better understanding of the essential requirements. Public education, supported by the exemplary conduct of reputable firms would, we believe, be more effective in the public interest at this time than concentration upon crusades against the exploiting fringe.

On the basis of the experience of the past 2 years we believe that the Investment Counsel Association, even though at this time including as members only a relatively small proportion of the total practitioners, can now safely and most effectively in the public interest expand its membership and public usefulness.

That completes the quotation from the report of the special committee.

Now, to summarize very briefly: The association feels very strongly that investment counsel clients should be entitled to safeguards comparable to those offered the public in their dealings with the legal, medical, engineering, and accounting professions. To accomplish this, we believe the best method to employ is that method by which these other professions have achieved their present high standing. It is the tried, proved, and economical method. It is already in operation.

Ours is a new profession. It is still in the development stage. We are not yet sure what particular methods, practice, and prohibitions may be to the best interests of our various types of clients. When we feel more certain of our ground, we shall ask for at least that measure of public supervision and regulation which is now accepted by the other recognized professions. Until that time, we believe the public interest can be better served without imposition of the additional legislation and uncertain and indefinite inquisition and regulation proposed in this bill.

Senator Wagner. Of course, Mr. Rose, "inquisition" is a rather strong word.

All right; that is your statement and not mine.

Mr. Rose. Some of us have not felt it was too strong—those of us who have read the bill and have tried to imagine what might take place under it.

As has been indicated by what I am afraid may have been a rather tedious array of historical and factual data, the Investment Counsel Association for the past 3 years has actively and aggressively been concerned with the problem of establishing and maintaining high standards in the practice of this profession. This has not been limited to practitioners in the field, but has embraced the beginnings of a rather broad and comprehensive plan of public education to these standards.

If now, at this critical period in the development of this professional association, we are forced to abandon the constructive job upon which we have embarked, in order to protect our very existence as well as the interests of our clients, that are now threatened by the imposition of legislation which may include—again—inquisitorial powers and regulation by a governmental agency, the momentum of this positive, constructive force will have been arrested. Our energies and abilities under such conditions would have to be devoted to the preservation of our existence as a profession, rather than to the establishment and advancement of standards within that profession. We earnestly hope that the association's worthy objectives, toward which important

progress has already been made, will not have to be placed in jeopardy by a reorientation to a completely defensive position.

Mr. Chairman, I imagine you will not want to continue much longer today; but Mr. Rudolf P. Berle, general counsel to the Investment Counsel Association of America, would like to comment briefly on some of the broader implications of Federal regulation in this field.

Thank you, sir.

Senator Wagner (chairman of the subcommittee). We are glad to have heard you, Mr. Rose.

Senator WAGNER (chairman of the subcommittee). Mr. Berle, how long do you think you will take?

Mr. BERLE. I think my statement can be concluded in 10 minutes.

Senator WAGNER. Then we should be glad to hear you now. Please proceed.

STATEMENT OF RUDOLF P. BERLE, GENERAL COUNSEL, INVESTMENT COUNSEL ASSOCIATION OF AMERICA, NEW YORK CITY

Mr. BERLE. My name is Rudolf P. Berle. I am an attorney, and am general counsel for the Investment Counsel Association of America.

I might say preliminarily that my reason for being interested in investment counsel matters has been due to the fact that, before this association concerning which Mr. Rose has testified was formed, I became peculiarly interested in the functioning of investment counsel, as such—largely by virtue of the impact of the requests for advice, that came to me as an attorney; because frequently in the course of my practice I found that clients were asking us for investment advice, and I knew perfectly well that we were not competent to give investment advice in that broad, comprehensive fashion in which investment counsel are supposed to give it; and it seemed to me that, peculiarly, it was important that there should be developed and should be crystallized as a profession which devoted itself to that type of problem which was present in the case of so many clients.

Senator HUGHES. Where do you practice, Mr. Berle?

Mr. BERLE. In New York City, sir.

Senator HUGHES. Very well.

Mr. BERLE. At the threshhold of any consideration of a bill for the regulation of investment advisers by the Securities and Exchange Commission, naturally lies the broad question as to whether regulation of any character by the Federal Government is appropriate. This committee is perhaps in a better position to consider such a broad matter of policy than the members of the investment counsel profession, since necessarily they may be open to the charge that any effort to resist regulation is motivated by selfish purposes. The Investment Counsel Association of America deems it appropriate, however, to bring to the attention of the committee in its consideration of the problem the various elements involved; but let it be emphasized further that in presenting these considerations, rather more fundamental matters are dealt with than technical questions of constitutionality.

I should likewise like to point out at the beginning that the definition of investment adviser, which is contained in section 45 (a) (16) of title I of this bill, is so broad that it includes many types of activity

to which my testimony will perhaps not apply, except perhaps indirectly. The remarks which I have to make are based primarily upon my contact with investment counsel, a term which applies to those investment advisers who maintain a highly personal and professional relationship with their clients and who are as remote from the vendor of a tipster sheet as a first-class surgeon is from the seller of patent medicines. Nevertheless, the effect of this bill upon what I may call true investment counsel is of the utmost significance, because the true investment counsel stands at the heart of the entire problem.

Perhaps, likewise, it would be well to emphasize that the Investment Counsel Association is fully as acutely aware of the deficiencies in the way in which the profession is conducted at the present time as is the Securities and Exchange Commission. Mr. Rose's analysis of the purposes of the association, clearly revealed by its code of professional practice, is ample proof of the efforts made by the association to standardize some of the practices at present existing. Recognition of evils, however, does not necessarily imply a determination of the method by which those evils are to be eradicated. It has in fact been characteristic of the association that its approach has been what I believe the Securities and Exchange Commission itself would concede to be the best, namely, to have the members of the profession deal with their own problems.

At the outset, may I say that I regard it as extremely unfortunate that the proposals for the regulation of investment advisers should have been coupled with the proposals for the regulation of investment companies. Investment counsel have only services to sell. Investment companies have securities to sell. The one is capable almost exclusively of the subjective approach; for in dealing with investment counsel, fundamentally you are dealing with individuals and the capabilities of individuals, reflected in the advice which they give. In the other, an objective approach is possible, for the handling of investment trust securities can at any given time be the subject of purely objective study. We feel quite strongly that these two subjects should have been segregated, inasmuch as the material necessary to formulate conclusions with respect to the one is utterly unrelated to the facts fundamental to the other. Since, however, the two are embodied in one bill, we have no choice but to deal with the situation as we find it.

Senator Hughes. You both manage your clients' money, don't you?

Mr. Berle. One of us sells securities to the public, and there may be no personal contact whatsoever. In fact, in most of the investment trusts I gather there is no personal contact whatsoever; whereas in our situation that highly personal relationship is of the very essence.

Now, Mr. Chairman and Senators, I do not appear here in any sense opposed to the idea of Federal regulation, as such. I sincerely believe that the Securities and Exchange Commission has rendered a great public service in the performance of such legitimate functions as the regulation of the issuance of securities and the regulation of national security exchanges, as well as in the field of public utility companies, so ramified in their structures that they reach out over the entire country. Furthermore, I believe this in spite of many of the criticisms of administrative operation, which not only leaves room for improvement but which I believe the Commission itself is the first

to recognize as a field which needs improvement and which can be improved.

However, a real question of policy arises when it is proposed to extend the functions of the Commission into an area involving the regulation of individuals who, in essence, are rendering personal service. The dealings between one individual and another, in the matter of giving advice on the investment of funds, fall into no established pattern; nor will these dealings ever fall into an established pattern, because of the fact that no two individuals who may seek investment advice will normally present precisely the same kind of human problem to the counsel whose advice is sought.

Perhaps this can be most aptly illustrated by the provision in section 204, subdivision (c) (2), which appears on page 100 of the print, lines 4 to 6, inclusive, which requires the registering investment adviser to file copies of every form of contract or agreement regularly used by the investment adviser between himself and his clients. I am prepared to defy almost anyone to tell me when a form of contract becomes a form regularly used. Investment counsel may very well have some standard form, from which variations are made to suit the particular situation of the particular client with whom they may be dealing; but to assume that all investment counsel fall into a mold, and to assume that all investment counsel's clients fall into a mold, is to negate the great variety which exists among human beings.

Even if some standard form of contract is customarily used, it may well be that the principal vice which should be prevented would lie in the special forms of contract made in special cases. Furthermore, to determine whether any such vice does exist, it would be necessary to conduct a detailed examination into the circumstances of the relationships between the investment counsel and his client. On its face, such a contract could well be of a type which the Investment Counsel Association, for instance, would heartily condemn; and yet it might well have been entered into without the slightest taint of fraud or concealment, simply because that was the kind of an instrument with which those two people, with their eyes open, chose to define their relationship.

It is the essence of our conception of the giving of investment advice for compensation that individuals seeking advice should not be forced into a standard mold. In fact, the moment the investment counsel begins to deal with his clients on any regimented basis, I think the best investment counsellor would tell you that he had ceased properly to perform his function.

I need only sketch a variety of instances to illustrate this point. With a fund of $100,000 to invest, the problems of the investment counsel will be utterly different for the widow having no other possible means of support, for the man with a wife and several children, for the unmarried man at the threshhold of his life, for the man of substantial additional resources besides this fund, for the client who holds a responsible and reasonably secure position of employment (to the extent that such exists today) for whom the fund represents accumulated surplus, and so forth ad infinitum. Only after the immediate financial and human requirements of these individuals have been analyzed, does the investment counsel begin to deal with the problem of the purchase of different types of investments. Yet, upon the accuracy of his initial analysis of these human characteristics may very

well depend the wisdom of his subsequent function of the actual investment of funds.

Now, it is into this area that it is proposed, through this bill, to introduce the regulatory functions of the Securities and Exchange Commission. That it is a relationship where fraud can wreak havoc is only too apparent. Yet, there are countless other areas in American life where fraud can be equally damaging, and yet where Federal regulation would hardly penetrate. The dentist, for example, who deliberately makes work for himself, would hardly be the subject of Federal regulatory authority.

Senator WAGNER. Did you say "dentist"?

Mr. BERLE. Yes, sir.

Senator WAGNER. Well, of course, the dentist does not deal in interstate commerce. However, he is regulated, is he not?

Mr. BERLE. Oh, yes; indeed, sir. There are a great many educational requirements he must pass, and which I hope at some time investment counsel will have to pass.

Senator WAGNER. Well, with him it is not a case where he is engaged in interstate commerce but there are regulations controlling the practice of the profession of dentistry.

Mr. BERLE. There you introduce an element of technical constitutionality which I preferred not to go into here.

Senator WAGNER. Well, I think it would be better to leave that to a court, but I was wondering why the one should be regulated or controlled and the other should not, in your opinion.

Mr. BERLE. I will say that I believe in the principle of Federal control of interstate commerce, and it is now construed a great deal more broadly than 15 years ago it was thought to extend. On the other hand, my thinking about this question is not along the line of interstate quality of the transactions involved but the professional quality.

Senator WAGNER. But you spoke about dentists, and I interrupted to remind you that of course the dentist has to have certain educational qualifications.

Mr. BERLE. Yes, sir.

Senator WAGNER. And he has to register.

Mr. BERLE. Yes; but my comment was in regard to the Federal regulatory authority. You can take care of the other question as you like.

Senator WAGNER. But you do not think there should be any regulation of investment advice?

Mr. BERLE. No Federal regulation.

Senator WAGNER. How about State regulation?

Mr. BERLE. With respect to that, since we are anticipating a bit, this is frankly my feeling: There is going to come a time, but I think that time is not yet, when the States have got to do for investment counsel precisely the same thing they do for doctors, and the same thing they do for lawyers. At some time in the future we have got to look forward to figuring out some method for determining the capabilities of those individuals who go into the profession of investment counsel.

Senator WAGNER. Then your view is: Why shouldn't you leave it to the counselors themselves to regulate the profession?

Mr. BERLE. Well, we would very much prefer to have the counselors themselves do it, but I do not think necessarily that is going to be the ultimate answer to the problem. As soon as the profession reaches a period of greater maturity than at the present time doubtless something will have to be done.

Senator WAGNER. Is that the reason why you say they should not be regulated, either by State or Federal authority, because the profession has not reached a stage of maturity?

Mr. BERLE. I think probably at the present time you could not effectively work out a system for examination of investment counsel. We have not as yet had sufficient experience with respect to just how those examinations should be written.

Senator WAGNER. All right; suppose we say we are not to have any examination of investment counsel, that it is a little early and we have not developed sufficiently to determine just what the test should be. How about having it known in some book in some public way who these gentlemen are—at least a registration of the fact that they are engaged in that particular profession, and I think a very important profession—something to do with their character and experience—merely having it recorded somewhere, showing conviction for a felony if that is the case, and not having the right to reject the application but having the information on record somewhere. Do you see any objection to that in view of what you have said?

Mr. BERLE. Mr. Chairman, you are now making a suggestion that is quite different from this bill I take it.

Senator WAGNER. I do not know how different it is; but I am trying to get your point of view.

Mr. BERLE. I am addressing myself more particularly to this bill because I think, as previous witnesses have indicated, it goes far beyond anything of that kind.

Senator WAGNER. These bills are always rewritten after we hear everybody concerned, and some very valuable testimony has been given on these different points. Surely the testimony adduced here before us has been very enlightening. The difficulty I am laboring under is this: I have had about 28 years' experience as a legislator, as you probably know.

Mr. BERLE. Yes, Mr. Chairman; I know that.

Senator WAGNER. And no matter how stupid a man may be he learns something. Very often one finds when there is a desire to regulate a particular class that is a little new, and the representatives of that class do not like the idea, if it is in the Federal Legislature they want the State to regulate them, and if it is in the State legislature they want Federal regulation. We are constantly confronted by that type of argument. In view of your own statement of what your hopes are in this profession—and I agree with you and think it very important—if I should have occasion to go to someone, in event I had anything to invest, in order to get advice, certainly I would want to know that they did know something and that they were reliable. As to the 61 members of this association, I suppose they are competent, and yet there are a lot of outsiders that I do not know anything about. I just wondered if you would object to a simple form of registration of some kind, to the end that we do not put a man who is just out of jail in that work, or somebody who has been engaging in all kinds of practices and has been enjoined. Probably he has not gone

to the point of being a thief but the court has decided that he should not engage in the sale of securities. I am sure you agree that one of that type ought to be exposed; that inquiry ought to be made as to whether he is a fit person to be so engaged. Now would you say that a simple form of that kind would be objectionable?

Mr. BERLE. The difficulty involved in that is simply this: I do not think you can escape this fundamental question of policy, of the application of Federal authority to what is essentially a highly professional personal relationship. I do not want to take refuge behind the comment you have made, that when in a State legislature, they want the Federal Government to do it, and vice versa, but it does seem to me it is definitely the kind of thing, involving as it does a highly and purely personal relationship, especially a professional relationship, that ought to be left within the area of State authority.

Senator WAGNER. I am afraid that is where I am dull. I cannot get that. If it is important that there be some form of registration we will say, and these gentlemen deal in activities that are under the jurisdiction of the Federal Government, I cannot understand why you say the Federal Government should not do it but the State might. In many cases the State would not have any jurisdiction at all. What is there here that produces that important distinction? I do not get it.

Mr. BERLE. The answer, sir, I think lies in a question: If that is true, then it seems to me you must be prepared to take the logical next step, and there is no reason why you should not require Federal registration of accountants and Federal registration of lawyers.

Senator WAGNER. Well, that does not follow unless you present a very good sound reason for doing it. You take these matters step by step, and turn only to Congress because it seems the sound policy to pursue. The one thing does not necessarily lead to the other.

Mr. BERLE. Is there no distinction between the two cases? Take for example our own case——

Senator WAGNER (interposing). We are just raising this question: Suppose a man is an investment counselor and—then there comes in the additional question—Suppose he is engaged exclusively in interstate commerce; what you you say about him?

Mr. BERLE. I cannot see——

Senator HUGHES (interposing). And he is engaged in giving advice throughout the country.

Mr. BERLE. I cannot conceive of such a case, because the essence of investment counsel is that he has personal contact with a personal client. The entry into interstate commerce is the second step in this relationship. The first step is when the client walks into the counselor's office and says, "I have this money and do not know how I should invest it." I think it is a human problem.

Senator WAGNER. Would you say that an investment counselor is not engaged in interstate commerce if he writes a letter to a prospective client in New Jersey and suggests to him that he come over to New York if he wants advice, or if he is in New Jersey and writes a letter to a prospective client in New York? Is there any aspect of interstate commerce involved in that at all? I am not sure myself but would like to have your view.

Mr. BERLE. I do not believe so in the simple case you put. I mean that that whole question, as to where the dividing line comes in the matter of interstate commerce—and you know so much better than I

do about it—is a very highly technical point. We have been extending the lines for the last few years. In many cases I think the lines have been very soundly extended to things that never previously were thought the subject of interstate commerce; but in connection with investment counsel I cannot get away from the fact that the essence of this thing lies in the personal contact between man and man, and that is the situation when the two get together and sit down and talk over the problem. Now, that is the heart of my whole point. If that is not true you have a wholly different set of considerations.

Senator HUGHES. You are talking of one class and I am talking of another class. You are thinking of the class that you come in contact with and that you represent. There appears to be another class, who advertise all over the country, hold themselves out that at so much a year they will advise clients, and that advice goes through the mails, and there are advertisements in newspapers. Almost everbody receives such circulars, and see the advertisements in newspapers sent through the mails. I do not have much money to invest but I know something about that. And there is another class of people who would not come into your association, could not comply with your requirements, I dare say.

Mr. BERLE. You are quite correct about that, sir.

Senator HUGHES. Those people are holding themselves out to people all over the country, and those are people whom we want to protect.

Mr. BERLE. I am making the distinction——

Senator HUGHES (continuing). Doubtless they are not engaged in the same kind of business, but they are making money out of people, and I do not know just how to approach that problem.

Mr. BERLE. I do not think you will find among all these investment counsel one but who will cavil as a matter of fact at your suggestion that they are holding themselves out as doing the same kind of business.

Senator HUGHES. Of course, I do not say that. You are doing a legitimate business. I have a high regard for the people you represent, but am speaking of the other class that try to come in under the same umbrella, not by your invitation it is true, but you cannot kick them out.

Mr. BERLE. Should you necessarily, for the sake of dealing with that kind of people, ignore the varied things I have already been preaching better than you so far as these highly professional men are concerned? Is there any reason why——

Senator HUGHES (interposing). I am not saying so at all.

Mr. BERLE. Is there any reason why, in order to deal with this question of investment advisers that you should start with a definition which is so all-inclusive that I do not believe even Mr. Schenker, with all due respect for him, and whom I regard very highly, can tell now who is going to be included. Shouldn't there be some of that thinking first?

Senator WAGNER. All distinguished lawyers can find words to convey what they mean if they have an objective in view. Going back again to the State legislature, and I do not like to go back too far, I remember when nurses were not registered and they themselves insisted upon legislation providing for registration because they thought it would give dignity to their profession. I also remember the case

of the osteopaths, where they insisted upon being registered, and in my time a bill was enacted into law and they were licensed.

Senator Hughes. And the doctors.

Senator Wagner. Yes; but I am now speaking about later days. Before that time there were the physicians. They themselves drafted legislation so as to give dignity to their profession. As Senator Hughes has said, I think yours is an important and difficult profession, and while commendable efforts have been made by your organization to put the profession on a high standard, I do not see how you can supervise—and you might challenge that word, so I will say how you can provide some form of bringing them together—to the end that somewhere there will be a record as to who they are. The words of this bill may be too indefinite or too comprehensive, but I do not quite understand why there is resistance to doing anything about it. You yourself admitted that sooner or later you hoped the time would come when there would be something provided.

Senator Hughes. Would not you gentlemen who are more deeply interested than anybody else probably, even suffer a little sacrifice or maybe a little hardship in order to bring in this other class that is now doing wrong things?

Mr. Berle. If I interpreted correctly what has already been said here this morning, it is more than a little sacrifice. I think it is a serious problem.

Senator Hughes. I mean in order to get them on record and know who they are.

Mr. Berle. Well, I cannot do more than I have already said. That is to say, it seems to me when you get into the area of the purely professional relationship that ceases to be a function of Federal regulation. If you include that within the area of Federal regulation you must necessarily logically be prepared to include a great many other things. Perhaps in my next few paragraphs here I can summarize that statement.

Senator Wagner. All right. You have been very generous.

Mr. Berle. My function is to be helpful if I can.

Mr. Rose, Mr. Chairman, if I might interrupt for a word?

Senator Wagner. Certainly.

Mr. Rose. When I mentioned in my statement that Mr. Berle would testify I did not mean to stop you from asking me questions about the association and pass them on to an attorney. At any time during this hearing I will be glad to discuss these matters that you are interested in as affecting our association.

Senator Wagner. We asked you some questions.

Mr. Rose. Yes; but I will be glad to try to answer any additional questions.

Mr. Berle. Mr. Chairman, shall I proceed?

Senator Wagner (chairman of the subcommittee). Yes.

Mr. Berle. Whether investment counsel lie on some dividing line—and I think this will answer the point of view of the members of the subcommittee.

Senator Wagner. All right.

Mr. Berle. Whether investment counsel lie on some dividing line, conceivably falling within the area of Federal regulation, involves a very fundamental question of political importance, and by political

I do not refer to politics. There is a real question whether the science of government properly embraces an extension of these regulatory functions to a highly personal relationship, such as is involved in that of the investment counselor to his client. For regulation in an area too vast and too intricate in its ramifications, where the vastness and the intricacy spring from the purely personal equation, may make the regulation so impossible of effectiveness that the result is worse than if it had never been undertaken.

I question seriously whether the conception of Federal government in America has reached or should reach a point in which personal professional relationships should be made the concern of Federal supervision. Yet, in dealing with this matter of the Federal regulation of investment counsel, I believe that Congress may actually be dealing with this highly fundamental problem. If the step is taken across the line with reference to investment counsel, the taking of that step may fairly be regarded as determinative of the policy involved in taking other similar steps into the field of personal relationships.

I realize fully that in the last 10 years we have witnessed in the United States a legislative extension of Federal authority into many fields previously untouched. I likewise realize that that extension of Federal authority really has been simply the recognition of changes and developments in social and economic structures preceding the legislation. In that respect, those extensions of Federal authority have been a response to a need. But that need has developed over the preceding two or three decades, and has corresponded to the development and changes in the financial and economic structure of the country.

No similar situation, however, applies to investment counsel. Actually, investment counsel as a profession is a thing of very recent growth. Investment counsel have sprung into being in response to the requirements of individuals for individual personal advice with respect to the handling of their affairs. It is perhaps not accidental that in the early stages, and to a very great extent today, when the problems of investment became as complex as they are, individuals sought this advice from lawyers and not from specialists. They sought that advice from lawyers because of the fact that in dealing with their lawyers they felt that they were dealing with people having professional responsibilities and to whom they could confide fully their own personal private problems.

Consequently, the whole genesis of investment counselling is a personal professional relationship. The inception of such a relationship has nothing to do whatsoever with interstate commerce or anything else. It primarily has to do with the solution of an individual's problems by a person whose advice he could trust.

If such a relationship is to be made the subject of Federal regulatory action, then there is no logical reason for the exclusion of many other personal relationships where advice and expert service is being obtained for compensation. Once it has been established, and I believe that this legislation may furnish the point at which the principle is established, the road is free on any logical basis for a wide expansion into many other fields. Before that barrier is hurdled, it seems to me that its implications should be very carefully thought out.

Closely related to this is another phase which cannot be emphasized too strongly. I have sometimes felt that the Securities and Exchange Commission has not fully recognized the extent of its power over men's reputations. I feel quite strongly that not enough thought has been given to the application of the Commission's investigatory powers to the case of investment counsel, and its power to destroy men's reputations by the mere process of investigation.

It is the stated purpose of title II, as expressed in section 202, to protect the public against fraud on the part of investment advisers in their dealings with their clients. In support of the stated purpose, the bill gives to the Securities and Exchange Commission that same set of powers of investigation which it has under the Securities Act of 1933 and the Securities Exchange Act of 1934. These investigatory powers are virtually unlimited. The pattern, which in the enforcement of these acts has been followed, has been one of extensive and thorough search of all the facts in any given case in advance of any formal action by the Commission. The Commission's trained investigators ferret out every possible lead which contributes to the building up of a case against the person or concern investigated, and in doing so have the support of subpena powers and of taking testimony under oath. Theoretically, these investigations are "private" until such time as the commission is prepared to formulate its charges. These preliminary investigations may extend over a substantial period of time and may involve the interrogation of large numbers of witnesses and the examination of vast quantities of records. The witnesses interrogated may have little or nothing to do with the major issue in hand, but their testimony is sought for corroborative evidence.

No such investigation can fairly be regarded as "private" after it has progressed beyond the very initial phases. In the financial district, at least, it rapidly becomes a matter of common knowledge that the commission is "investigating" something.

Should the investigation prove unfruitful in the production of evidence sufficient to formulate formal charges, there is no exculpation of the individuals investigated, presumably on the theory that no charges have ever been formally made. The investigation simply lapses.

But the rumor and the stigma which goes with the rumor does not lapse. In fact, it hangs as a cloud over the persons who were drawn in question, until such time as it becomes apparent that nothing has come of it. That time may be many months. It may even run into years.

Now, when you are dealing with investment counsel, you are dealing with reputation. Men who depend for their livelihood upon the opinion of others as to their integrity and their capabilities, are really dependent upon a thing of utmost fragility.

May I impress upon this committee that the mere commencement of an investigation by the Securities and Exchange Commission of an investment counselor, if attended by even the slightest public knowledge, carries with it the virtual certainty that the man's reputation will be damaged if not worse. The mere fact that his integrity has been brought into question, and the knowledge of that fact by even a few people, will instantly raise doubts which will lead clients to cancel their connections and to seek their investment advice elsewhere.

You may say that this would be unjust, but there is no sense in not being realistic about it, because one of the first people that an investigator would seek to interrogate would naturally be the man's own clients. People are sensitive and have a right to be sensitive on the score of the integrity of the people to whom they may entrust their fortunes for investment. If a suspicion of lack of integrity has been raised, the investment counsel's client will very likely take the position that he would rather be safe than be sorry.

What is even more serious, the investment counselor thus made the subject of investigation has no satisfactory way of combating the suspicion aroused by the commencement of the investigation. He may not even know what the charges formulated against him are to be. He has no means of answering anything. An investigation even may be started on one ground and followed up on another, for the initial authorizations are broad enough to cover many matters.

The result is that though an investigation may be dropped before it is fully under way, the damage done to the subject of the investigation may prove to be almost as irreparable as if it had been pursued through to the stage of public consideration by the Commission. When you are dealing with questions of character, let me repeat, you are dealing with the most delicate and at the same time the most valuable thing which investment conuselors, or indeed anybody, has. The slightest unskillful use of the Commission's powers in its investigatory field can reek a savage and most unjust result.

Yet this bill takes no account of these facts and simply treats the investment counselor, whose character and reputation lie at the foundation of his success, precisely as you would treat a share of stock or a bond.

These things are being said with the full realization that no regulatory power is worth the paper that it is written on unless there is coupled with it a full kit of punitive powers, and further that punitive powers are ineffective unless they in turn are coupled with full investigatory authority. I realize fully that there is no sense in being sentimental when faced with the task of uncovering and punishing fraud. In some instances, perhaps, the paramount public interest in defeating fraud may justify injuries which nobody wishes to inflict. But as has been pointed out, where the subject of the regulation rests so fundamentally upon personal character and reputation, it is of an equal paramount public interest that that reputation shall be fully protected until justification for its destruction has been established beyond a reasonable doubt.

In the light of the general conditions which have been expressed, detailed discussion of the clauses of the bill would serve no useful purposes. Should the committee determine, nevertheless, that some legislation of this character is called for, we are ready to give out specific suggestions in the effort to attempt a correction of some of the more serious problems arising from its terms as drafted. But the major question of policy of course comes first.

Much for example has been said here in the hearings on title I, concerning the rule-making authority under section 36 (a). Certainly some comprehensive treatment of that should be made in any redrafting of the bill. Administrative agencies admittedly must have rule-making authority, for without it they cannot function effectively. But I believe it to be a sound principle of administrative law that the

rule-making authority should always be circumscribed by the specific grants of authority in the enabling legislation. Only in that way can the fundamental doctrine that the statement of policy is the prerogative of the legislature be preserved.

In conclusion may I emphasize again our approach to this whole problem of the regulation of investment counsel hinges on the determination of a fundamental question of policy in the extension of Federal regulatory authority. There is no disposition to duck the responsibility which any profession has in the development of sound standards and clean practices in the exercise of that profession. But in a nascent profession, such as that of investment counsel, in the first analysis and in the last analysis the main spring of improvement and growth must come from within.

Senator HUGHES. I am sorry that the representatives of investment counsel have the feeling they may be injured by even raising the question as to whether they should be regulated or not. I am not as much alarmed about its reputation as I am about what you may do in your association to cure the evils that exist, and try to get into your association all members who are engaged in your profession, or as many of them as you can, to the end that we may in some way if necessary deal with those who do not want to come in. They are the men who have offended. We will grant all that you have said about the excellence of your organization and all that, but still there remains the duty to protect the public.

I am not going into your question of whether it is constitutional or not, or whether the State should regulate you or the Federal Government should regulate you, but certainly it is something that should be looked after, now or later, to the end of having the people who are engaged in your business, live up to the standards you have established, and your standards are good. That is the way I feel about it.

Senator WAGNER. Senator Hughes, I am with you on that. Are Mr. Loomis or Mr. White here?

Mr. WHITE. I am here, Mr. Chairman.

Senator WAGNER. Did you want to speak again?

Mr. WHITE. I wanted to say something about title II.

Senator WAGNER. Oh, you do. Then you want to say something in addition to what you have already said?

Mr. WHITE. Yes, sir. I spoke on title I.

Senator WAGNER. Against this provision?

Mr. WHITE. Yes, sir.

Senator WAGNER. No compromise? [Laughter.] You will be brief I take it, because we had hoped to finish this line today. It is half past 5 o'clock now, and doubtless some of the folks present are a little weary. As you gentlemen know, there is much to be done when we get back to our offices.

Mr. WHITE. It would take 15 or 20 minutes to make my statement.

Senator HUGHES. Won't you be here tomorrow?

Mr. WHITE. Oh, yes.

Senator HUGHES. I will leave that to the chairman, as to whether we will go on any longer this afternoon.

Senator WAGNER. We will have time to hear you tomorrow morning.

Senator HUGHES. He says he will be back here tomorrow.

Senator WAGNER (chairman of the subcommittee). Mr. White, you are on the list and we will hear you tomorrow morning.

The subcommittee will now adjourn until 10:30 o'clock tomorrow morning.

(Thereupon, at 5:35 p. m., Monday, April 22, 1940, the subcommittee adjourned until 10:30 o'clock the following morning.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

TUESDAY, APRIL 23, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, April 22, 1940, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, and Herring.

Senator Wagner. The subcommittee will come to order. Mr. White?

Mr. White. Yes, Mr. Chairman.

Senator Wagner. You may proceed.

ADDITIONAL STATEMENT OF JAMES N. WHITE, OF SCUDDER, STEVENS & CLARK, INVESTMENT COUNSEL, No. 10 POST OFFICE SQUARE, BOSTON, MASS.

Mr. White. Mr. Chairman, as I told you before, I am a general partner in the firm of Scudder, Stevens & Clark.

I am appearing in opposition to title II, but first I want to tell you our position on Federal regulation generally. It is this: We would not oppose registration, or regulation, if there were a need for it, and if the interests of our clients were adequately protected, and if the objectives of the bill and the powers of the Securities and Exchange Commission were adequately prescribed.

The last two points—protection of the interests of our clients and definition of the objectives of the bill and of the powers of the Securities and Exchange Commission—relate to the provisions of this particular bill. The first point is whether there is any need for registration or regulation of any kind. If we thought there were any need for legislation, we should gladly agree to it.

In this connection, may I make one comment on yesterday's testimony? There may have been some misapprehension arising from what Mr. Rose said concerning the association. The association represents only a portion of the profession, not because the remainder of the profession does not observe the same standards but because many firms have doubted the advisability of an association at this stage of development. My firm, for example, is not a member of the association. There is no basis for any impression you may have gathered that nonmembership in the association implies any lower standards. I am sure that Mr. Rose did not mean to convey any such implication.

Senator WAGNER. Well, we do not understand it so either.

Mr. WHITE. Now, gentlemen, what is the case for regulation? We know the case as stated in the Securities and Exchange Commission report to Congress and in the testimony of its representatives before this committee. If there is any other case for title II, we do not know it and, though I may be wrong, I seriously doubt whether it exists.

The case for title II as stated by the Securities and Exchange Commission is based entirely on certain testimony given before the Securities and Exchange Commission by the very group of witnesses from the investment counsel profession whom you heard here yesterday. From that testimony, the Commission has apparently gathered that we believe that there is a racketeering element in the profession which needs regulation. That testimony was given at a hearing before the commission in February 1938.

I want to tell you about that hearing very briefly. A group of investment counsel firms, practically the same group which has been represented here, met by invitation with the Securities and Exchange Commission. Our attendance, while voluntary, was requested by the Commission, and we were glad to help in making ourselves and our business known to the Commission. The conference took the form of a public hearing, with Mr. Schenker, on behalf of the Commission, asking us questions.

The hearing dealt only briefly with the history of the investment counsel profession and with its methods of operation. Very early in the hearing, Mr. Schenker, indicating some general approval of the way we carried on our business, suggested that there existed in the broad field of those giving investment advice what he described as a fringe of racketeers. Specifically, he referred to a so-called financial advisory service advertising in the newspapers that they would furnish the name of a $2 stock likely to advance in value. The suggestion was, of course, that this racketeering fringe ought to be regulated.

This question was asked—referring to this supposed tipster element:

Question. However, it is a condition and not a theory which confronts the Commission. That type of thing exists, does it not?

Answer. When I say yes, I do not know. I could not put a name to any individual.

Question. I am not being critical of Town Topics—

that was the name of the financial advisory service—

but that type of organization which gives that type of investment service exists, isn't that so?

Answer. Yes.

I mention this brief colloquy because it is typical of the testimony that we gave at this hearing before the Securities and Exchange Commission, and because it is that testimony which seems to furnish the principal basis for this attempt to regulate the investment-counsel profession.

I must say I think we were all no doubt glad to find that the Commission apparently approved of the job that we were doing, and we were quite willing to agree with the suggestions of Mr. Schenker that there was a racketeering element of tipsters which need regulation. Accordingly, it is not surprising to find that the subsequent testimony, consisting largely of long questions as to the importance of regulating this racketeering fringe, contained answers varying from outright

assent to statements to the effect that if racketeers did exist, it constituted a problem.

I think that we were quite right in agreeing with the Commission that tipster services may constitute a racketeering fringe presenting a problem. We do not know anything about them, and certainly can't say they don't exist. However, if anyone reads our testimony as agreeing that tipster services are in any way a part of our profession, we have been very badly misunderstood. You have already heard what investment counsel are and how they work. A tipster service is something else altogether.

It has been suggested that this sort of racketeer may attempt to impose upon the public by using the name investment counsel. Even if that were so, even if they did use the name, they still are easily differentiated. If additional regulation of the tipster and the racketeer is necessary or desirable, such regulation is certainly possible without subjecting investment counsel to the same treatment.

Just in passing I want to say that I doubt very much whether they do use the name investment counsel. I have never seen it used in that sort of advertising, and in the list of advertisements which appeared in the back of the Commission's report to Congress there was no mention of the words "investment counsel" or of any phrase that they would seem to hold themselves out as investment counsel.

The Securities and Exchange Commission's report to Congress contained a great many advertisements of tipster service. Not one of them, as far as we could see, used the words "investment counsel." That is why we are opposing regulation or registration of investment counsel. If we are wrong on our facts, we shall be glad to change our position.

Now as to this specific bill before the committee. I want to tell you what this bill seems to me to do. First of all, however, I would like to remind you how the Securities and Exchange Commission representatives described title II before this committee. Mr. Schenker described it in a few words. He said to this committee:

> What is this registration business? What does it amount to? We simply have a piece of paper on which they put their name and address. Who are their partners? What is their background? What is their experience? What is their discretion over their customers' accounts? And we ask them if they engage in any other business. Then, if they have been convicted in connection with a securities fraud, or if they are subject to an injunction in connection with a securities fraud, we have the right * * * to say we will not register you.

Judge Healy said that the real intent of title II "is to see to it that men with this kind of a record (criminal records) cannot go into the business of being investment advisers."

That was the Securities and Exchange Commission's description of title II. It sounds reasonable enough.

Now, having in mind that the case for regulation is the racketeering fringe, and that the Commission has described title II as a simple registration to keep out of business a demonstrated felon, let us look at the actual provisions of title II.

In the first place, look at the findings which Congress is asked to make. Do they relate to a racketeering fringe? They do not. Congress is asked to find that the advice given by investment advisers relates to the volume of trading in and prices of listed securities, and of securities in the over-the-counter markets, and of securities issued by national banks, and of securities issued by member banks of the

Federal Reserve System; that their work influences the policies of large financial and banking institutions; and that their work is done in such great volume as to affect interstate commerce, securities, markets, the national banking system, and the entire national economy.

Now that is quite a statement, and, without any undue modesty, I can say that it does us too much credit. However, the point is that those findings have nothing to do with a racketeering fringe—the Securities and Exchange Commission doesn't for a moment think that the racketeers are of such great economic importance. These findings, even as applied to the investment-counsel profession, represent gross exaggeration at the best; but certainly they cannot be intended to relate to any tipster minority.

In the second place, the regulatory provisions of the bill go far beyond any simple registration or census. This point has been touched on before, but it's worth repeating. What does the registration statement contain? It must contain certain specific items and then "such further information and copies of such further documents" as the Commission shall prescribe by rule or by order. What happens to the privacy of our clients' affairs and of our sources of information with that provision in the bill? That privacy just does not exist.

Again, you have incorporated by reference in title II the broad power given by title I to make rules to carry out any of the provisions of the title. Judge Healy doubts whether this power confers any substantive regulatory power on the Commission and suggests that it is limited to the definition of certain technical terms, and so forth. I would feel better if I could be sure that he was right; taken with the proposed findings of fact and the statement of abuses alleged in the declaration of policy in title II, this seems to me a very dangerous provision.

But there is one point which seems to be more important than anything else that can be said about title II. After serious study we have come to the conclusion that what this bill really does is to give the Securities and Exchange Commission the power to make a thoroughgoing investigation of every detail of the business of the true investment counsel profession, and to follow it up with a detailed regulation of that profession.

We have come to that conclusion for several reasons. Certainly the bill gives the Securities and Exchange Commission power to make such a detailed investigation. Section 38, incorporated by reference into title II, says in so many words that the Securities and Exchange Commission has the power to investigate "any facts, conditions, practices, or matters" which it may deem appropriate for the purposes not only of enforcing the law but also of serving as a basis for recommending further legislation.

Another point is very significant. Title II has been proposed to you as a method of regulation of investment counsel by registration, but note an important omission. Nowhere in title II is there any provision for keeping registration statements up to date—no provision requiring amendments when facts change, no provision for annual or supplementary reports. In other words, under the bill as it has been introduced, an investment adviser once registered may change the entire character of its business; may change its partners, officers, and directors, or its place of business; may change its practices with respect to clients' funds and accounts; and wouldn't have to

report any of those changes to the Securities and Exchange Commission.

Now every other registration statute requires that information set forth in a registration statement be kept up to date on some reasonable basis. Why has any such provision been omitted here? It can only be because this title is not intended as a completed regulatory scheme but rather as a grant of full power to investigate and then to provide additional and detailed regulation. In fact, the absence of any provision for keeping registration statements up to date is by itself enough to make future legislation essential.

The CHAIRMAN. You favor the incorporation of such a provision.

Mr. WHITE. Well, with registration, but there is no point unless you have it. And, if you have registration, you might as well keep it up to date.

Senator WAGNER. Are you opposed to registration in any form and under any circumstances even though the language be such that your objections would be eliminated? Do I understand that you still object to registration?

Mr. WHITE. Senator Wagner, registration by itself is worthless. Registration without the power to do something about registration is of no value, is it?

Senator WAGNER. I am not so sure about that.

Mr. WHITE. But I should not ask you a question.

Senator WAGNER. That is all right, but you understand that my mind is open and that I am seeking information.

Mr. WHITE. We just feel that registration leads to investigation, and that investigation leads to regulation; and it is possible for a good deal of controversial theory on economics to creep into regulation. That is the point.

Senator WAGNER. All right. You may proceed.

Mr. WHITE. On this point of the real purposes of this bill let me mention again the proposed findings of fact. As I pointed out, they are all related, not to the existence of racketeers in the investment advisory business but to the economic importance of investing money—an ideal basis for as elaborate an exploration of the investment counsel profession as could be imagined.

Finally, there is the small but very significant phrase in the proposed declaration of policy contained in section 202 that the title is for the purpose of mitigating "as far as presently practicable" the abuses referred to in that section. Take all these factors together—the nature of the findings of fact, the broad power to investigate, the absence of any provision for keeping registration statements up to date—and we cannot doubt that this bill will be construed by the Securities and Exchange Commission as a mandate from Congress for a thorough-going investigation of the whole business of investment counsel, with further detailed regulatory legislation to follow.

We think that no case has been made which should cause Congress to authorize such an investigation or to grant such a mandate.

Senator WAGNER (chairman of the subcommittee). We thank you very much.

Mr. WHITE. And I thank you for hearing me.

(Thereupon Mr. White left the committee table.)

Senator WAGNER (chairman of the subcommittee). Mr. Loomis?

ADDITIONAL STATEMENT OF ROBERT H. LOOMIS, PRESIDENT, LOOMIS, SAYLES & CO., INC., BOSTON, MASS.

Senator WAGNER. I hope your statement is not just a repetition of what you said here before.

Mr. LOOMIS. I shall try to stay away from repetition.

Senator WAGNER. All right. You may proceed.

Mr. LOOMIS. The testimony yesterday afternoon appeared to degenerate into an argument that was satisfactory to no one. We drifted into the question of constitutionality and interstate commerce—arguments that delight the lawyer and confuse the layman, but lead nowhere.

This entire question involves both the public interest and our interest but the truth of the matter is that they are one and the same thing.

We have no desire to oppose registration or any other form of legislation if it is in the public interest for the simple and selfish reason that if any group such as ours whose livelihood depends on public trust and confidence is acting against the public interest, it cannot long endure.

Now, what is registration? Registration is but a step, but where does it lead? Taken alone it cannot protect the public interest against abuses in any field. We feel that registration would hurt our business so we do not want Federal registration unless it has been demonstrated that it is necessary.

Why did many of those testifying yesterday shy off from even accepting the theory of a simple census and thus expose themselves to a very natural skepticism concerning their open-mindedness on any subject? The first step, therefore, let us say, is simple census. Let us find out that you exist and where is your place of business. This information is worthless unless having found out who is in the business it is possible to find out what kind of a business he conducts.

Therefore, the next step is taken—investigate, and what is the point of investigating without pretty broad powers so that essential information cannot be withheld.

Again, what is the point of making the investigation if the investigatory body can take no action should it discover abuses, so the following step is clearly called for—regulation, to wit, the ability to see to it that businesses are conducted according to rule and punishable when that rule is departed from.

This is why we would answer the question, "Are you against registration?" in the negative, unless the need is demonstrated fact, and would be forced to answer it in the affirmative, if the reverse were true.

Now, I am opposed to title II of this bill because, first, it would appear to me that the need and demand for this legislation has not been established; and, secondly, I believe that this proposed legislation might become harmful to the best interests of those for whose protection the bill is intended.

I believe that if investment counsel now knew adequately what the Commission was driving at, if we knew the complete objectives of the Commission—if it knew why the Commission jumped from the census idea 2 years ago to the idea of complete regulation, we would be in a much better position to cooperate intelligently with them.

On the face of it, title II appear rather mild and innocuous and it is only after careful study of it and also a study of what is implicit in its present requirements, that I have decided it is drastic enough to indicate that someone must have thought the situation pretty bad.

For example, the matter of registration of investment advisers: The uninitiated might well consider that the bill was most simple and restrained. In testimony which I gave before counsel of the Securities and Exchange Commission in Washington some time ago, when asked as to whether or not I considered registration advisable, I made the distinction between registration and a census and said that I would be willing to have a census taken. The reason for my making that distinction has been fully justified by the terms of the present bill.

The present bill is not a census and not a mere registration either, but also calls for regulation.

If at the present time there were huge and widespread scandals; if it was obvious that fraud was being perpetrated widely; in other words, if enormous abuses were prevalent right now and we were sure of them, there might be justifiability for immediate urgency of legislation to prevent widespread fraud. But in the apparent absence of this, at least so far as my observation is concerned, it would seem reasonable to make haste slowly, to legislate upon knowledge and not upon ignorance.

The discussion yesterday seemed to indicate two classes of undesirables: First, the "fringe" as typified by the tipsters; and, second, the firms which fall within any reasonable definition of investment counsel and yet have not high standards.

There is little argument on the first group, but we fear that the impression was created that those who are members of the association are on one level while those outside of it are unwilling to adopt such high standards.

The impression was thus created that the vast majority of counsel firms had standards that were to some degree questionable. Mr. Rose testified that in his opinion there was 150 to 200 firms of real investment counselors in the country while only 18 belonged to his association. This impression is very far from the truth.

We do not belong to the association because we do not now, and did not when the association was formed, believe that there existed abuses in the investment counsel profession which required the corrective influence, if any, of an association.

An association is formed generally because some group benefit can be obtained or some group benefit given. As investment counsel do not have dealings with one another, or jointly with third parties, we did not see how there was anything to be gained selfishly from banding together in an association.

Since we failed to discover the existence of abuses, we were something less than enthusiastic about getting involved in the formation of an association which we felt sure had erected a straw man without which it could not exist. Yesterday you got a glimpse of the straw man. We recognized that when and if an association were of such size and national reputation that elimination from its roster would carry such a stigma that the expelled member could not operate, it would have a corrective influence, but again we could see no point in starting in to build a corrective influence until we knew that we had

something to correct. In other words, we were not interested in forming an association just for the sake of having an association.

Our clients are paying minimum fees of from $125 to $250 four times a year, and of course for those having more than $100,000 these quarterly fees may run into the thousands of dollars. It is customary to have these contracts cancelable every quarter. I believe that you will agree with me that these clients would not pay out, actually write a check for hundreds or thousands of dollars every quarter-year, and continuously through the years, unless they knew pretty well what they were paying out this money for and to whom they were paying it. Every 90 days they think this out pretty carefully.

I believe that title II is discriminatory legislation. Let me develop this point. During the past 10 to 20 years, many investment counsel have followed a long and very expensive process of acquiring and training personnel in a new profession, of building up and maintaining research departments up to 100 people costing large sums annually to provide proper facilities for clients, of training personnel in the methods of counseling for clients, and of generally molding all their endeavors into what now constitutes a fairly clearly outlined profession. They have overcome enormous difficulties, and through the greatest depression in history have built up the confidence of a large number of clients in the technique and process of a profession.

This discriminatory character of the bill is probably my strongest criticism of title II of this bill. Do you realize that every lawyer the day he passes his bar examination is automatically exempted from this bill? In other words, any lawyer, whether he knows anything at all about investments, is assumed to be fully competent to practice this profession of investment counsel.

It is a well-known fact of course, that lawyers and law firms, particularly in New England, direct the investments of hundreds of millions of dollars in this country. What is there in the training for the law that makes the lawyer automatically so fully and adequately equipped for investment counsel that he is thus put outside this proposed legislation entirely? Is it because the lawyers have made such a startling success of investment management and there is no evidence of felony in their administering of funds? The investment-trust witnesses testified that lawyers were involved in the most flagrant investment trust scandals, yet lawyers are exempt!

I cannot believe that Congress has such an objective in mind. Furthermore, I feel very strongly that the clients of investment counsel today would raise a strong protest, first against the insinuation that they do not have sense enough to choose proper investment counsel, and secondly against this attempt to discriminate against an outstanding group in America that has spent time and money solely to represent and promote the interests of the investors themselves.

Now, it is a serious matter when you take any steps to cast a cloud of suspicion over this young, vigorous, high-minded industry or profession. Prior to this time I had supposed that legislation was passed after the establishment of need for it. While I admit that I am merely a layman and do not understand the law, this is the first time to my knowledge that legislation has been enacted prior to the proof of need. Please bear with me while I attempt to review the facts in this situation as I see them.

First of all, the Securities and Exchange Commission was instructed by the Congress to investigate the investment trust field. As has been shown during the past several weeks, practices not in the public interest occurred in this industry and, in some cases, the public suffered. However, the Commission does not stop here. They decide that while they are urging the enactment of legislation to cover investment trusts, they might just as well include an entirely separate field, that is, the investment counsel or investment advisory field.

As far as I am concerned, I have not been made aware that there is either a demand for such legislation on the part of the public or that it is in the public interest. The only reasons that I have gathered from the hearings held a couple years ago, or from the testimony presented during this hearing, is that the Securities and Exchange Commission feels there are possibly two reasons why legislation covering us should be enacted: First, because perhaps there are abuses in the investment counsel profession. They do not state that there are any, in fact, Mr. Schenker, during the original hearings, repeatedly said that he was not interested in us as a group; that we were all right as far as he was concerned.

I am afraid that on yesterday the representative of the Investment Counsel Association may have given you the impression that there were abuses when he referred to the fact that all members of the association did not originally come up to the standards prescribed by the association. Here again, I wish to state as emphatically as it is possible for me to do that I, personally, am not aware of abuses practiced by the investment counsel profession which are detrimental to the public interest. The standards of practice set up by this group individually, I dare say, are as high as were ever established in the early life of any of today's professions. If there is any feeling in this committee that our organization would not need the qualification standards of the Investment Counsel Association, I would like to refer him to our code of practices, written by us to govern ourselves, and filed with the Securities and Exchange Commission.

The only other reason given me as to why the investment advisory field needs regulation is because there seems to be, in the minds of the Securities and Exchange Commission at least, an outer fringe in the industry whose practices are not up to the standards of ours. That may well be. I expect there is an outer fringe to everything. It has not yet been proven to my own satisfaction, nor has the Securities and Exchange Commission proven to the committee as far as I know that this so-called outer fringe, these so-called tipsters and what not, are important enough in our national economy to justify the enactment of legislation which in its very essence endangers our very business. I have not been told how many exist, how important they are, how many of those that do exist are good, and how many are bad. In my own mind, I have not been convinced that this legislation or any legislation will catch them anyway. They are a nimble lot and they move fast. I am not so sure but what the Federal Bureau of Investigation or other departments of the Government might still be far better equipped to deal with them than the Securities and Exchange Commission.

How can they exist? Simply because there are and always will be people who wish to take a gamble on \$2 or \$5 with the hope that they are going to get rich. But because this nebulous, undefined field appears to exist, it seems necessary in the minds of the Securities and

Exchange Commission to cause all investment advisers to register, which is simply the step before regulation.

We have been asked would we mind a simple registration. Yesterday it was mentioned that the nurses and the dentists had registered and were required to pass certain examination. I feel certain that in both cases there was a demand and need established prior to the legislation requiring them to register. I do not believe, in this case, the demand has as yet been established.

One further thought, gentlemen, before I leave—Yesterday Mr. Rose in his testimony seemed to indicate that a standard of qualification could be set up for this industry. Experience has proven that some sort of standard was needed in the case of the dentists and the nurses, prior to the time they were required to register and by which they could be individually judged. The distinctions between those groups and ourselves are, first, that we ourselves have not as yet been able to define a reasonable standard of qualification for investment counsel; and, second, that the investment counsel profession has taken steps, wholeheartedly from their early beginning to establish a high standard of practice governing their own actions.

One more word. I think the simple matter of the whole thing is this: There has not been demonstrated, so far as any of the investment counsel firms that are here assembled are concerned, any definite outline of the need for legislation. Now, as I say——

Senator WAGNER (interposing). Are you limiting yourself to investment counsel or speaking generally?

Mr. LOOMIS. To investment counsel.

Senator WAGNER. All right.

Mr. LOOMIS. I might also include "the fringe." I have not heard any argument about them. I have merely been told that there is such a thing. I think it would have to be proved that there was a fringe, what such a fringe constituted, and all about it, before there was a demonstrated need.

Senator WAGNER. I misunderstood you. I thought you said so far as the entire field of investment trust was concerned.

Mr. LOOMIS. Oh, no.

Senator WAGNER. Because we have had some testimony on that as you know.

Mr. LOOMIS. Surely.

Senator WAGNER. All right.

Mr. LOOMIS. Since there has been no establishment of a need for this legislation, I cannot see any basis for it. I question a lot whether the Congress wants to begin to legislate in a matter for which there has been no need therefor demonstrated.

One more word. If the Congress and this committee, in spite of what we have said, believe that some sort of bill should be enacted into law, even though there has been no basis for its enactment, I will say this: That the profession, my concern among them, will stand very ready, anxious in fact, to cooperate with the Congress and with the Securities and Exchange Commission to make just as good a bill as we possibly can, for the good of the profession, for the public interest, and for ourselves.

I thank you.

Senator WAGNER (chairman of the subcommittee). I thank you.

(Thereupon Mr. Loomis left the committee table.)

Senator WAGNER (chairman of the subcommittee). Professor Dodd.

STATEMENT OF PROF. E. MERRICK DODD, JR., HARVARD LAW SCHOOL, CAMBRIDGE, MASS.

Senator WAGNER. Professor Dodd, we will be delighted to hear from you. You ought to know about this.

Mr. DODD. Mr. Chairman and Senators: I came down here to talk about that portion of the bill that deals with investment trusts. I would, however, like before I deal with that, to say just a word about the investment-counsel aspect of the bill which we just heard discussed by other witnesses.

I have been somewhat astonished as I have been listening to the testimony today and read the testimony of yesterday, at the suggestion that because investment advisers, investment counsel, properly enough regard themselves as members of a profession, that that is the reason why they should not be regulated.

It seems to me quite obvious that just the opposite is the case, that it is our normal practice under our laws, both State and Federal, to regulate professions; that when people hold themselves out as competent to render professional services to the public, we do regulate them. We regulate the professions to keep undesirable people out. We regulate the legal profession, we regulate the medical profession, we regulate the accounting profession, and we regulate all of the major professions. With my own profession, the legal profession, we regulate not only who can get in but who can stay in. As a member of the bar I am subject at all times to disciplinary measures on the part of those two courts of whose bars I am a member, the Federal and the State courts. I can be disciplined, and I can be disbarred.

Furthermore, in their relatively minor——

Senator WAGNER (interposing). I take it that is done for the public welfare.

Mr. DODD. Of course it is done for the public welfare; and I am not one of those who regards a public official as a totally different sort of human being because we label him a "judge" or label him an "administrator." It would not alarm me in the least if I was, as a lawyer, subject to discipline by the Securities and Exchange Commission instead of being subject to discipline by the Supreme Judicial Court of Massachusetts.

Moreover, it is not accurate to state, as Mr. Loomis stated, that lawyers are exempt from that provision of the bill. They are only exempt insofar as they give advice about investments incidental to conducting their ordinary professional duties as lawyers. What that means it seems to me is obvious: If I, as a lawyer, have a client who is accustomed to come to me for legal advice, and in that connection I have become thoroughly familiar with the financial affairs of that client, who is very likely to be a woman or other person not perhaps very cognizant of investments, and if he or she asks me a question about whether a certain investment he or she proposes is a good risk, the bill allows me to answer the question to the best of my ability, without saying: I cannot give you any advice about that because I am not a registered counsel.

But that does not mean that because I am a laywer I can hold myself out as giving good investment advice to all comers. I am not exempt from the provisions of the bill because I am a lawyer, but

only exempt in the narrow field where I can give investm[illegible] as incidental to my ordinary duties to my regular legal clie[illegible]

Well, so much for that. Let me turn to what I came dow[illegible] speak about, that portion of the bill that deals with investme[illegible]

I have been teaching corporation law at the Harvard Law School for 12 years, and I taught at other law schools for some years before that, and prior to that I practiced law, including a good deal of corporation law.

As I have been teaching corporation law I have become more and more interested in the investment trust situation, primarily for two reasons: First, because it is clear to me that if investment trusts are properly managed they can perform an enormously important service for the investor, particularly the small investor. The large investor can get competent investment advice, can employ investment counsel; and if he is a large investor he can have his own investment adviser. The small investor cannot do that. Investment counsel serve only large investors. The small investor cannot get diversity because he has not enough money to try to invest directly in stocks, say common stocks, himself.

The primary function of the investment trust is to give the small investor those two services, (1) expert selection, and (2) diversity.

In addition to that, I feel that the investment trust, if properly managed and if it regains its popularity with investors, which it has to a considerable extent lost, can perform a very important service to industry, because it can furnish to industry institutional buyers of common stock.

We have great institutional buyers of bonds. We do not have any substantial number of institutional buyers of common stocks, and that is one of our primary difficulties in marketing corporate equities.

So that the investment trust has long interested me as something that could perform a very important service, both to the investor and to American business.

I have long been very much bothered about what seems to me clear—the fact that while there are some excellent investment trusts, that the industry as a whole has not adequately been performing that service. As a student of State corporation laws I have long been well aware of the fact that under State laws, notably under the laws of Delaware, under which laws most of these trusts incorporate, this enterprise is wholly unregulated, so that there are ample opportunities for managements to engage in activities detrimental to the investor.

There are not only ample opportunities for the employment of improper practices, but there is no question that those opportunities have been used to a very large extent. Some 2 years ago the Securities and Exchange Commission made a very illuminating study of one group of investment trusts, Equity Corporation and its subsidiaries. Now they have made a similar study on a much broader scale, and that study, which I have carefully examined, is very revealing. It reveals not only outright looting—and if that were all that it revealed I should not be tremendously worried, perhaps, because, while there has been a good deal of it, that has not been a widespread practice so far as I can make out, although there has been a distrubing amount of it—but it reveals other things which are very dangerous to the investor even though one might not label them as outright looting.

[illegible] first place, it is clear that for a very large part of the investment industry we do not have any substantial publicity. When [illegible] ment trust is issuing new securities it comes under the [illegible]s Act. If securities are registered on the Stock Exchange they come under the Securities Exchange Act; but many of the investment trusts come under neither of those acts.

Quite apart from that the major evils in the investment trust field as I see them will not be cured by publicity. Those major evils which will not be cured by publicity as I see them, are primarily two, although there are some others.

In the first, place, there are evils which result from self-dealing; from the fact that so many of our investment trusts are managed by persons who are in the business of selling securities, or are brokers of securities, or are connected with corporations that want to find a market for their securities, so that opportunity for a dangerous kind of self-dealing is peculiarly prevalent in this industry.

Now, a man may be on both sides of a bargain and still be honest, but a man cannot be on both sides of a bargain without having his judgment affected by that fact.

Furthermore, self-dealing is particularly dangerous in this kind of enterprise because of the nature of the enterprise. For instance, if the management of a large steel company were composed of people who owned a lot of worthless land in the dust bowl, it would be nevertheless impossible for them to sell out to the steel plant, to substitute their desert land in the dust bowl. On the other hand, it is not only possible but very easy and is not at all infrequent for the managers of an investment trust, with an excellent portfolio, to dispose of all or a large part of such portfolio and substitute less desirable securities therefor.

The liquidity of the investment trust makes the danger of self-dealing far greater than that possible in the case of industrial plants and public utilities.

Now, this bill deals with that problem in two ways: It deals with it in part in section 17, which prohibits certain transactions of that kind. It deals with it in part in section 10, by making certain persons ineligible after 1 year as officers or directors of investment trusts.

Well, now it may be asked, and I think it has been asked by people who have appeared before you: Why that double-barreled protection? If you have a provision against self-dealing, why not stop there?

Well, as I see it, for two reasons: In the first place, it is one thing to prohibit self-dealing, and another thing to make that prohibition genuinely effective.

We have had prohibitions against self-dealing in corporation laws for generations, and self-dealing has gone on. It is very hard to stop it. It is very hard to stop it because it is very easy to conceal. A man may sell his own securities to a corporation through a straw man, so that self-dealing is not easily discovered.

It is only partially effective to say that people shall not sell their own securities to their trusts. They will still do so to a considerable extent. We will not succeed in stopping them.

In the second place, there are dangers that do lurk in a certain type of interlocking directorates that are not self-dealing. We will say that an investment trust buys a large block of securities of some corporation. It becomes pretty obvious that it is in the interest of the

trust that those securities should be sold. But to throw those securities on the market will depress the market for that particular type of stock. Corporate managements do not like to have that happen to their securities.

Let us suppose, therefore, that we have a very influential common director of the investment trust, a person who is a director of an investment trust on the one hand, and on the other hand a director of the corporation whose securities it owns. He is not in a position to look at that matter solely from the standpoint of the interest of the investment trust. As a director of the other corporation he does not want sales which will seriously affect the market for that corporation's securities. Now, self-dealing does not prevent that because there is no dealing there where there ought to be action.

So for those two reasons I feel it is clear that a mere prohibition of self-dealing, though thoroughly desirable, thoroughly necessary, is not enough; that it is important to go further, as this bill goes, and to provide that certain persons shall be ineligible after an adequate period for readjustment, as members of boards of directors.

Section 10 of the bill makes certain persons ineligible but the class of persons who are made ineligible represent a relatively small number. There will still remain eligible plenty of experienced financial experts if that section is enacted into law.

It is of course no novelty for the Congress to limit the availability of certain persons for membership on boards of directors. We have done that with the railroads, making interlocking directorates between railroads and certain other corporations, or between other railroads, unlawful, except with the consent of the Interstate Commerce Commission under the Interstate Commerce Act. We have limited the eligibility of certain persons as directors of banks under the Banking Act. Various classes of persons cannot be directors of banks without the approval of the Federal Reserve Board. We have done the same thing with the public utilities in the Holding Company Act, under which a large class of persons are ineligible as directors without the consent of the Securities and Exchange Commission. The Clayton Act makes it illegal for persons to be directors of certain types of competing corporations. So it is no new thing for Congress to say that the dangers involved in certain kinds of interlocking directorates are such that that type of directorate should be forbidden by law.

Next, as to capital structure, which is in my opinion one of the most important features of the bill. As you know, while the bill does not affect the capital structure of existing trusts, it does provide that future investment trusts shall have only one type of security—common stock. Why should we do that with investment trusts if we do not do it with other corporations?

Well, as I see it, we should do it with investment trusts because there is a very substantial difference between the issue of senior securities by investment trusts and the issue of senior securities by industrial companies. Generally, the portfolio of an investment trust is almost entirely composed of common stock; and frequently the portfolio of an investment trust is to a large extent composed of the common stock of companies that themselves have senior issues of securities. The result is that debentures of an investment trust or preferred shares of an investment trust are an interest in common

stock, at one stage and often several stages removed from the operating enterprise.

As I see it, there are two objections to that. In the first place, it tends to deceive or mislead the type of investor who is not very sophisticated about financial affairs; and that is very important, in view of the fact that so many of the investors in investment trusts are small investors, and in view of the fact that the primary social function of these trusts and their primary public usefulness is to serve the small investor. The small investor is often—although not always, of course—a rather unsophisticated investor; and the danger is that he will buy preferred bonds or shares without realizing that what he is getting is merely a limited interest in common stock. That is a very real danger.

What is perhaps more serious than that is the fact that even if he does realize what he is doing, he is running risks which even the fairly sophisticated investor does not appreciate.

What is the effect of issuing preferred stock in an investment trust? You are promising the preferred stockholder that you are going to give him priority in dividends, up to usually something like 6 percent. How are you going to do that? You must earn your operating expenses, in addition. You can do that only by averaging 6½ or 7 percent on your money. It is a rather difficult thing to do; it is an almost impossible thing to do at certain periods of the business cycle, except by speculation. Therefore, you are tempted into speculation.

Moreover, the effect of the business cycle is this: In the first place, preferred shares of investment trusts are rarely issued except in booms. Experience indicates that they are very difficult to sell except in booms. People will not buy preferred shares in this sort of enterprise except at a time when they feel that stocks are going up and that, therefore, preferred shares in a fluctuating pool of common stocks are fairly safe. So they are sold in booms. That means they are sold when common stock prices are rather high.

Well, unhappily, booms—so far as we know—are always succeeded by slumps. Then what happens? What happens then is that your asset values fall off and that your common stock becomes nearly wiped out or wholly wiped out, so far as asset values are concerned; but its voting power is rarely wiped out. It generally retains control, although it has a very limited asset value.

Another thing happens under these circumstances—and has happened—and that is that your preferred dividends pile up. The figures compiled by the S. E. C. are these: That of 58 companies with preferred stock issues, the issues of 35 of those companies went in arrears. Out of preferred stock issues at the end of 1939, the total arrearages aggregated nearly $80,000,000.

Well, what happens then? You have got a lot of arrears piled up on your preferred stock issues. Generally, you still have control in the common shares. You have got control in the people whose hope of dividends is very remote because of these preferred arrearages ahead of them.

What are they tempted to do? Well, they are not only tempted to do, but it has been shown that to a very large extent they do do one of three things—perhaps more, but three things particularly: One thing is to engage in speculation. They are speculating now with preferred stockholders' money. They have very little hope of a

come-back for the common stock unless they do speculate and take long chances. They have got practically nothing to lose, because they are speculating with other fellow's money and not with their own. So they are tempted to speculate, and they very frequently do speculate.

Another thing that they are tempted to do and which they have often done is, as the S. E. C.'s study shows, to sell out to somebody who wants to buy control for sinister purposes. Control may be in the hands of a perfectly honest man; but there are men who, as owners of common stock, are discouraged in their own ability to get much out of this enterprise, because of the preferred stock ahead of them. Somebody comes to them—somebody who sees an opportunity, by having control, to use that control for purposes of looting the trust—and offers a substantial price for what is otherwise worthless common stock, merely in order that he may get control. Because the common stock is worthless, except for control purposes, the temptation to sell out without inquiring very carefully into the kind of fellow to whom you are selling out is a very real temptation—a temptation that I should hate to be confronted with, myself. That temptation has been yielded to over and over again.

However, they may do neither of those two things. In many cases what they will do will be a third thing. What they will do will be to put pressure of one sort or another on the preferred stockholders to consent to a recapitalization—to a recapitalization which will reduce or radically change the rights of the preferred stockholders, so that the common stock may get back into the picture.

Now, Mr. Chairman and Senators, it is unfortunate that our State laws make that process an almost wholly unregulated process and a very dangerous one for the preferred stockholders. Take the law of Delaware—and I mention Delaware because something like half of our investment trusts are incorporated there: Under a law of Delaware it is possible—as the recent *Havender case* in Delaware indicates—to make radical changes in the capital structure of a Delaware corporation as incidental to a merger between a parent and a wholly-owned subsidiary. I should not say "incidental"; because what you do is that you make the merger for the sole purpose of changing the capital structure. In Delaware you can change the capital structure not only under the amendment section of the statute but under the merger section of the statute. If you proceed under the merger section of the statute, there is no provision for a separate vote by the preferred stockholders. Accordingly, you can put in a merger that radically affects preferred stockholders' rights, that gets rid of their accrued dividends entirely, for example—as that case decided—without even getting rid of the common stockholders, providing the common stock has control.

However, suppose the preferred stockholders do have a right to vote: Even there, the dangers are very great. The management is normally in the hands of people elected by the common stockholders, whose interests are allied to theirs. They are the people who put out the literature that comes to a stockholder with his proxy, indicating to him why he should vote for this. It is as though we had a political campaign where all the campaign literature came from one side and none of it came from the other side and where the other side was unorganized.

The directors elected by the common stockholders control the dividend policy of the corporation. It has very frequently happened that preferred stockholders have been put into a mood to consent to radical changes in their rights by starving them for a while from dividends, even though dividends could legally have been paid, and then intimating to them that if they would only "play ball" with the management and put through the kind of amendment that the management is seeking, then in some mysterious way the corporation's ability to pay them dividends would suddenly be increased.

Then, again, as in the *International Paper case,* there are situations where it is in the interest of both groups, preferred and common, that some change be made, such as a wiping-out of deficit by reducing capital stock; but the common stockholders, with the aid of the management, will take the position, "We will not vote for this change, even though it is in the interest of both parties, unless you, the preferred stockholders, will grant us a large concession and will in effect bribe us to vote in the way that it is in our own interests to vote, anyway."

For years I have watched litigation in the State courts with regard to recapitalizations; and, frankly, it frightens me. The State courts have felt that the legislatures have granted these broad powers, that the courts should not interfere with the exercise of those broad powers unless they are used not merely unfairly but outrageously. Generally, they can be upset only for fraud; and what the Delaware court calls "fraud" has to be something very, very raw, I can assure you.

The same is true of many other of our courts. They have felt that since the State legislature did not give them control over these reorganizations, and since it left it to the stockholders' hands, therefore the court should interfere only in rare cases.

We have there something totally different, gentlemen, from what we have with regard to reorganizations where creditors are involved. There the Congress has wisely provided a statute under which we have very careful judicial supervision of such things.

Senator WAGNER. Senator Hughes, will you preside for just a few moments? I will be back almost at once. I did not want to miss hearing any of it.

(At this point Senator Wagner (chairman of the subcommittee) left the hearing room.)

Senator HUGHES (presiding). All right, Professor Dodd; please continue.

Mr. DODD. Where creditors' rights, including bondholders' rights, are involved, we not only have a statute calling for court intervention and in some cases S. E. C. advisory opinions, but we now have an opinion of the Supreme Court, in the *Los Angeles Lumber Products Company case*, which makes it the duty of the court to reject any reorganization plan which does not thoroughly protect the priority claim of bondholders.

They have nothing of the sort where we are merely changing the capital structure of a corporation; and such changes may be of a sort greatly to reduce the priorities of the preferred stock, and yet be unassailable under our State laws.

No doubt it is possible to deal with this matter to some extent by putting special protective provisions in the preferred-stock contract; but as I see it, there are very serious difficulties in the way of that.

In the first place, even if you provide that in certain cases voting rights will go over to the preferred stockholders, actually it is generally impossible for the preferred stockholders to oust the management put in by the common-stock holders, even where they would like to do so; because there is no way of organizing them. You cannot beat somebody with nobody, as has often been said in politics; and it is equally true in the management of American corporations. The existing board of directors is in. They will send out proxies urging the preferred stockholders, if they now have obtained the voting control, to reelect them. If you are not going to reelect them, you have to get a rival slate, and somebody has got to organize the opposition. The preferred stock is usually held in small lots by small investors. Usually there is nobody there to organize the opposition.

Furthermore, I feel sure that if you somehow succeed in making preferred-stock provisions really protective, preferred stock would not be issued, anyway. The reason it is issued is because it does enable holders of the common stock, even if the corporation gets into difficulties, still to run the show; and if you could really effectively give the preferred-stock holders power to run the show, if you could give them power to liquidate the enterprise, for example, if it was in their interest to liquidate, those rights of the preferred stockholders would then be regarded by the common-stock holders as so dangerous that preferred stock would not be issued.

(Senator Wagner then reentered the hearing room and took a seat at the committee table.)

Mr. Dodd. I simply do not believe that you can put into your preferred stock issues provisions that are really protective to the preferred stock; I doubt if you can do it at all. If you can do it, I am sure that you would thereby produce a situation where promoters, who generally expect to be common stockholders, would not want to issue any preferred stock.

This bill proposes to prevent new issues of preferred stock and new issues of bonds. The bond situation is very similar, except that a so-called bond—which is nothing but an interest in a pool of fluctuating common stock—is an even more anomalous investment than preferred stock in such an enterprise.

As I say, the bill proposes to prevent such issues in the future. They are not being issued today; they will not be issued unless there is a boom, and that is the very time when it is dangerous to issue them, because it is the time when this pool of assets will be way up and when the danger of shrinkage will be peculiarly great. However, there are a large number of such issues on the market at the present time; and, therefore, the bill goes on to endeavor to furnish some protection to those who now hold preferred stock in these enterprises.

In many cases that stock is issued on terms which give them very little protection. The bill endeavors to give protection to them in a number of ways. One is by giving the S. E. C. power over recapitalization plans. The reason why I am thoroughly convinced that our State laws are inadequate on that and that regulation of recapitalization plans is necessary, I have already tries to indicate. They are not regulated by courts. They are proposed by managements, ordinarily by managements identified in interest with the common stock. The cases in which they have gone through in one way or another, despite the fact that they were plainly unfair to the preferred holders, have

been painfully numerous in the past and will be painfully numerous in the future unless we regulate them in some way.

This bill proposes to regulate them by giving the S. E. C. the same sort of control over them that it now has in similar cases with regard to public utilities under the Holding Company Act.

There is also the danger to which I adverted: that if the common stock ceases to have any substantial asset value, then the present holders will be tempted to sell out to undesirable persons seeking to get control. Experience indicates that generally those persons who seek to get control try to do so not with their own money but with someone else's money and that, accordingly, what they do is to use one investment trust to buy control of another. For that and other excellent reasons, the bill makes it unlawful for one investment trust to buy securities of another. There are many reasons for that. One is this reason that I have just been suggesting: that investment trusts are often used as a means by which unscrupulous people will get control of another investment trust, wherel that can be done with a small outlay, owing to the fact that control is in the common shares, whereas most of the money belongs to the preferred.

Another obvious objection to the purchase of securities of one investment trust by another is that it leads to pyramiding one investment trust on another; and there, again, it leads to control by people who have no substantial financial stake in what they are controlling.

So, in my judgment, the bill very wisely prohibits one investment trust from buying control of another.

Another important provision of the bill is that with regard to dividends. Our State laws—notably, again, Delaware law—are extremely lax with regard to dividends. In Delaware, dividends may be paid out of any kind of surplus; and that means that the directors of a Delaware corporation, without consulting the stockholders, may label a large part of the stockholders' original contribution as surplus, and then later on ladle that out in dividends. That may be done without warning the stockholders, at the time when they are getting the dividends, that they are unearned.

Since, in normal American practice, dividends have normally come out of earnings, the investor normally assumes that is what he is getting. He thinks he is getting income. It may be merely a return of his principal; yet, under Delaware law, you do not have to tell him that it is return of his principal.

That is bad enough when you have only one class of stock. It becomes much worse when you have two or more classes; at least, if the Delaware law would be interpreted by the Delaware court to mean what it seems to say, there is nothing in that law to prevent the use of surplus, paid in by the preferred-share holders, by the senior security holders, to pay dividends even on junior securities. There is nothing in that law, if it means what it seems to say, to prevent the paying of dividends to common-share holders out of so-called paid-in suplus, even though the remaining assets are substantially less than the amount which has been promised to the preferred-stock holders as a preferential claim in liquidation.

In other words, you may issue preferred stock with $10 par or $10 stated value, if it has no par, with a liquidation preference of $100. You may issue that stock for $100, if you can get people to pay that much for it; and then, if the Delaware law means what most lawyers

think it means and what it literally seems to mean, you can use that $90, paid in by the preferred-stock holder, to pay dividends on the common stock, despite the fact that by doing so you make a mockery of the preferred-stock holder's liquidation preference.

We need a different sort of dividend law than that; and this bill, if enacted, will give us a different sort of dividend law with regard to investment trusts—which are, as I say, that type of security which is so largely invested in by the small investor, the man who is peculiarly unable to protect himself and who can peculiarly ill afford to lose.

Obviously, you cannot have effective dividend control unless you have some control over accounting practices. You cannot have publicity of accounts that means anything unless you have some control over accounting practices. Therefore, this bill necessarily, as I see it, gives the Commission some control over the accounting practices of these corporations; and the control that is thus given the Commission does not differ substantially from the control that the Commission already has under the Securities Act and under the Securities and Exchange Act, over corporations that come within those acts. As I have already said, many investment trusts do not come within either of these acts.

There is just one other provision of the proposed act about which I should like to say a word before I close; and that is a provision with regard to the settlement of litigation against the management. Litigation against the management of any corporation is normally carried on by the common-stock holders. Obviously, the management will not sue itself. Thus, except in those rare cases in which you get a complete overturn in the personnel of the management, litigation attacking misconduct by the management, which has injured the corporation, is practically always brought by the common-stock holders. That situation gives rise to this very dangerous state of affairs: The stockholder who litigates is ostensibly litigating for the corporation. In the majority of cases, however, he holds a relatively small amount of stock; and if he wins for the corporation, he gets relatively little out of it, himself. Therefore, he is under a strong temptation, if he gets the opportunity, to make some kind of settlement which will primarily enrich him rather than the corporation. His lawyer is also under a considerable temptation to consent to a settlement, if the settlement involves substantial lawyer's fees.

On the other hand, the defendants—the management—do not particularly care whom they pay. They are chiefly interested in paying as little as possible. The result is that very frequently you have a situation in which there will be some sort of agreement between the plaintiff—the shareholder, suing ostensibly on behalf of the corporation—and the management, for a settlement which will benefit the plaintiff's lawyer by giving him a good fee and, perhaps, benefit the plaintiff, either indirectly through splitting with his lawyer or otherwise by direct payment to him, but which will be of very little benefit to the corporation. There is no party to the litigation who has any interest in objecting to that settlement; it benefits everybody who is actually litigating.

Senator WAGNER. Professor Dodd, may I ask a question right there? Is there not a requirement under rule 23?

Mr. DODD. Yes, sir; I was coming to that in just a moment. There is now a requirement under rule 23 to the effect that, as far as the

Federal courts are concerned, such a settlement cannot be made without the consent of the court. That is quite true.

The difficulty, as I see it, is that it is extremely difficult for the Federal judge to know, except in the most obvious and flagrant cases, whether the settlement is reasonable or not. Let us suppose that the settlement is made in the early stages of the litigation. The plaintiff has made a lot of charges. The judge does not know whether the plaintiff can prove all of those charges or half of them or none of them. A settlement is proposed, in which the corporation is to get a little. The plaintiff is for it; his lawyer is for it, because it is part of the settlement that he will get a fairly good fee. The corporation gets something. It is argued to the judge that the plaintiff's chance of recovery is dubious and, therefore, anything the corporation gets is velvet, and he had better assent to it. The judge has no machinery for investigating whether that is so or not, and there is no person before him in the court who really represents the interests of the corporation. Consequently, the judge must get his information from people no one of whom really has the corporate welfare at heart at all.

It seems to me that it is clear that the judge needs help in making up his mind with respect to whether or not a proposed settlement of that kind is reasonable. This bill gives him a way in which he can get that help. If the litigation is in a Federal court, the judge must wait for an investigation by the S. E. C. and an advisory report. If the litigation is in a State court, the judge does not have to accept the services of the S. E. C., but he is offered the opportunity of availing himself of this service if he desires it; and I feel sure that many State judges would desire it.

There are many other provisions of the bill. The ones that I have mentioned are those that stand out in my mind as the most important and most necessary.

I shall say just a word with respect to the bill as a whole: We have here an industry which is somewhat comparable to a savings bank, in that it takes the small investor's money and invests it for him. It invests it in a somewhat different type of security, but it performs a very similar service. Unlike the savings bank, it is wholly unregulated at the present time. Serious abuses have resulted from that situation.

It is clear to me that it needs regulation and that it needs Federal regulation. An investor in California may buy on the New York Stock Exchange an interest in an investment trust incorporated in Delaware and subject to Delaware law. The only body that can adequately deal with that situation, by way of regulation, is the Congress of the United States. Every provision in this bill is aimed at an evil which has been demonstrated by evidence of what has actually taken place. There is no provision in the bill that, in my judgment, goes farther than is reasonably necessary in order to cure those evils.

The bill leaves the investment trust completely free as to its investment policy, provided only that the investment trust sticks to the type of investment policy that it announced when it organized and when it sold its securities. If the investment trust wants to be a somewhat speculative enterprise, it can be such, so long as it does not indicate to investors that it is going to be a more conservative enterprise.

Consequently, I say that the bill leaves investment trusts quite free to perform their investment functions; it merely puts certain limita-

tions on a kind of conduct that has been proved to be dangerous. In the main the bill does that by specific and definite provisions to be enacted by the Congress. However, it is obvious that a bill that proceeded wholly along those lines would have no flexibility in it, whatever. You would be ordaining a Procrustean bed for every investment trust, without regard to the circumstances.

Therefore, in order to introduce into the bill a certain flexibility, certain powers are given to the S. E. C. The majority of those powers are not powers to make the provisions stronger, but they are powers to grant exemptions from certain provisions which, although generally desirable, yet as applied to a particular situation might seem needlessly harsh.

I am sure that you will have a far more workable statute if you do give a substantial amount of discretion to the Securities and Exchange Commission. All the primary questions of policy are settled by Congress, if this bill passes. The discretion given is discretion as to matters of detail.

I believe that such discretion is necessary in order to provide that amount of flexibility which must be permitted if the proposed act is not to become too rigid.

That is all, Mr. Chairman, unless there are questions.

Senator HUGHES (presiding). Are there any questions to ask?

Senator WAGNER (chairman of the subcommittee). I believe not, thank you.

Senator HERRING. No; thank you.

Senator HUGHES. Thank you, Professor Dodd.

Is Judge Fletcher present?

Mr. FLETCHER. Yes.

Senator HUGHES. Judge Fletcher, we shall be glad to hear you.

Mr. FLETCHER. About 10 minutes is all I want; and I should be willing to go over until tomorrow, if that suits the committee better.

Senator WAGNER. There is only this, Mr. Fletcher: I talked to the S. E. C., and I think all of us are agreeable to what you want done. I think you can put your statement in the record, if you want to; because I think everybody will agree to what you want done.

Mr. FLETCHER. Well, I have no desire to be oratorical.

Senator WAGNER. We are practically in agreement on it, so just put your statement in the record.

Mr. FLETCHER. Shall I just address a letter to the chairman?

Senator WAGNER. Didn't you have a short statement ready?

Mr. FLETCHER. I did not have one written out; no, sir. However, I can prepare one.

Senator WAGNER. Well, get a statement ready and send it to the committee by tomorrow; and it will be inserted in the record.

Mr. FLETCHER. Surely; that is very nice.

(The statement referred to is as follows:)

My name is R. V. Fletcher. I live in Washington. I am a lawyer and general counsel of the Association of American Railroads. I speak here for practically all of the class I railroads of the United States, comprising more than 95 percent of the entire mileage of operating railroads in the country. I appear here for the purpose of suggesting a clarifying amendment, the effect of which, if adopted, will be to exempt from the terms of S. 3580 companies subject to the Interstate Commerce Act and companies whose entire outstanding capital stock is owned or controlled by companies subject to the Interstate Commerce Act.

Railroads are subject to the Interstate Commerce Act in the matter of the issuance and sale of their securities. Railroad affiliates and subsidiaries owning

securities are subject to a certain measure of regulation by the Interstate Commerce Commission. It has been the general policy of Congress to exempt from regulating statutes having to do with the issuance and sale of securities all such activities of railroads and their affiliates as are controlled by the Interstate Commerce Commission. Quite obviously such a policy is wise because there should not be any overlapping of authority or any conflict between two Government agencies. Upon these considerations, the acts relating to the work of the Securities and Exchange Commission invariably provide for the exemption of railroads with respect to all features that are under the control of the Interstate Commerce Commission.

The Interstate Commerce Act, as it stands now, contains a certain measure of regulation applicable to railroad subsidiaries and affiliates. It is perhaps not necessary to spell through the act and point out the extent to which these subsidiary and affiliated companies are regulated. I say this by reason of the fact that the Senate has passed and the House now has under consideration a bill known as S. 2903, which is an act to amend the Interstate Commerce Act by extending the regulating authority of the Commission over railroad subsidiaries not actually engaged in transportation.

That act defines subsidiaries as covering companies 10 percent or more of the outstanding voting securities of which are held by carriers or by subsidiaries or both. In addition, the term "subsidiary" is defined as a company which the Interstate Commerce Commission finds is controlled, whatever may be the method of control. The act deals also with controlling persons and with affiliates.

It is worth mentioning that by section 4 of this act, the Commission is given the power to require annual reports from railroads and from the owners of railroads and to require subsidiaries to answer any questions which may be propounded by the Commission. This section 4 of S. 2903 goes into great detail with respect to the visitorial authority of the Commission. I call attention particularly to the following language, which is found in lines 7 to 19, inclusive, on page 8 of S. 2903 as it passed the Senate:

"The Commission is hereby authorized to require that every subsidiary which is not a carrier or an owner or a motor carrier file with the Commission an annual report, which shall consist of its balance sheet as of the end of the twelve-month period determined under paragraph (2), its income account for such period, and its profit and loss account as of the beginning and the end of such period, and such report shall classify separately the accounts shown therein representing (a) transactions between the reporting subsidiary or subsidiaries and the controlling carrier, (b) transactions between the reporting subsidiary or subsidiaries and all other subsidiaries of the controlling carrier, and (c) all other transactions."

It will be seen that the authority is very broad.

By examining section 9 of S. 2903 and particularly the language found in subparagraph (13), it will be seen that subsidiaries of carriers, where the subsidiaries are themselves not carriers, are subject to the provisions of paragraphs (2) to (6) and (8) to (11) of section 20a of the Interstate Commerce Act. An examination of the paragraphs referred to shows that by reason of the language just referred to, the Interstate Commerce Commission has complete control of the issuance and sale of all securities issued by railroad subsidiaries, with one exception. There is a proviso that if the subsidiary issues securities to the owning carrier (a matter in which the investing public is not interested), then the Commission may not supervise such issuance.

An examination of subparagraph (14) of section 9 of S. 2903 found on page 16 of the bill as it passed the Senate shows that after a named date it shall be unlawful for any officer or director of a carrier to hold the position of officer or director of a subsidiary, without the consent of the Interstate Commerce Commission.

Not to labor the matter unduly, it is clear that S. 2903 covers in a general way, as to railroads and railroad subsidiaries, the same field which is sought to be covered as to other types of securities by S. 3580.

A careful examination of S. 3580 rather indicates that perhaps the bill was not intended to cover railroads and their subsidiaries. Certainly these subsidiaries are not investment companies in the oridinary sense of the word. However, there is language in section 3 of S. 3580, as well as in section 6, dealing with exemptions, which leaves the matter in doubt. In order that all doubt may be removed, the Association of American Railroads is suggesting that S. 3580 be amended by inserting on page 7, between lines 24 and 25, a new paragraph, reading as follows:

"Any company subject to regulation under the Interstate Commerce Act and any company whose entire outstanding capital stock is owned or controlled by such company."

It is respectfully submitted that unless an amendment of this character is embodied in the act, much conflict and confusion may arise.

April 23, 1940.

Senator Hughes (presiding). Is Mr. Sholley here?

Mr. Sholley. I have a statement to make, which I am willing to file, if that will be satisfactory.

Senator Hughes. All right.

(Mr. Sholley's statement is printed at p. 663.)

Senator Wagner. Very well; and the statement of Professor Dodd is to be put into the record.

(The statement referred to is as follows:)

Statement of E. Merrick Dodd, Jr., Concerning S. 3580, A Bill For the Regulation of Investment Trusts

I am, and have been since 1928, a teacher of the law of corporation finance at the Harvard Law School. As such, I have devoted much time and attention to investment trust problems. I have done this for three reasons: In the first place, because I believe that investment trusts, properly managed, can serve one of the primary needs of the small investor, the need for some method by which he can invest in sound corporate equities with adequate diversification of his investment and, in doing so, have the assistance of disinterested investment experts; secondly, because I believe that it is vitally important to the successful operation of our whole economic system that investment in corporate equities be encouraged, and I believe that if the investment trust can regain the confidence of the investing public, which it has very largely lost, it can furnish us with institutional buyers of equity securities comparable to those large institutional buyers of bonds—banks and insurance companies—which provide a ready market for the senior securities of corporations; thirdly, I have been concerned about the investment trust problem because my studies of state corporation statutes and the court decisions interpreting them have made me acutely aware of the practically total absence of regulation of these trusts and the opportunities for injury to the interests of investors, which such lack of regulation makes possible.

That these opportunities for injury to the interests of investors have frequently been taken advantage of has long been well known. It was known to the Congress when in 1935 it instructed the Securities and Exchange Commission "to make a study of the functions and activities of investment trusts and investment companies * * * and the influence exerted by interests affiliated with the management of such trusts and companies upon their investment policies." That report has now been published and as a result in place of vague general knowledge that something was wrong we now have a thoroughly documented study which enables us to determine with precision the exact nature of the evils which have existed and which continue to exist under our unregulated investment trust system.

The investment trust resembles the savings bank in that both are institutions for the preservation of the savings of the American people particularly those of limited means. It resembles the savings bank also in that the persons who manage it are given control over a pool of liquid assets which in the absence of effective regulation, they can use as they see fit. It differs from the savings bank in that unlike the savings bank it is subject to practically no regulation. It differs from the savings bank also in that its portfolio is composed primarily of equity securities so that the investor expects to take somewhat greater risks than he expects to take if he puts his money in the savings bank. But he expects and is entitled to expect that the risks which he takes will be only those which are inseparable from investment in equities and that his money will not be used for purposes which benefit the management and those closely identified with it rather than the investor with whose savings the trust is financed.

As the Commission's report abundantly demonstrates, the unregulated investment trust has, in many cases, been operated in a manner which is not in accordance with sound fiduciary principles. There have been a disquietingly large number of cases of outright looting, but looting is already illegal. The primary need for regulation is not because of such looting but because of other evils which are much more widely prevalent. These evils, as I see them, are primarily two. In the first place, a very large percentage of our investment trusts are managed by persons who are, or are closely connected with, dealers in securities

or security brokers and hence have interests definitely adverse to the trust—in the case of the dealers, an interest in selling their own securities to it; in the case of the brokers, an interest in multiplying security sales in order to increase selling commissions. Many of these persons are persons of undoubted honesty, but honesty is not enough to prevent that warping of the judgment which comes about when a man is on both sides of a bargain—when arm's-length dealing is nonexistent. The other major evil is that, through the issue of large quantities of nonvoting senior securities and through the pyramiding of trusts, one superimposed upon the other, control is in many cases exercised by persons elected by those who have little or no financial stake in the enterprise, and often little or no hope of obtaining dividends from the normal operation of such trusts and who therefore frequently yield to the temptation of seeking to profit from their control in devious ways at the expense of the senior security holders whose investment they control.

Senate bill 3580 is designed to meet these and other evils which are not theoretical but actual. I can in the time at my disposal discuss only its major provisions.

First, there are those provisions which are designed to prevent the injury to investors which comes from management of these trusts by improper persons. These provisions are of two kinds. In the first place, a narrowly limited class of persons, including chiefly those who have been convicted of a crime in connection with some security transaction and those who have made willfully false statements in an application for registration, are made ineligible to act as officers or directors (sec. 9). In the second place, certain kinds of interlocking directorates, which experience has indicated are fraught with danger to investors, are—after 1 year—prohibited by section 10. It has been urged that the prohibition against self-dealing, which is contained in section 17, makes the prohibition of interlocking directors, contained in section 10, unnecessary; but the prohibition against self-dealing is not self-executing, and the history of American corporate finance plainly demonstates that such prohibitions are very difficult to enforce. Furthermore, if investment trusts and the corporations whose securities they hold have interlocking directors, certain undesirable results not prohibited by the provision against self-dealing are likely to follow. For example, if an investment trust owns securities of a corporation which has certain influential common directors, pressure is likely to be exerted on the trust to refrain from selling the stock of the other corporation because of the possible depressing effect which such sale may have on the market price of such stock, even though the interest of the trust may require that such sales be made.

Congressional precedents for imposing limitations on interlocking directorates are numerous. Such limitations have been imposed with respect to railroads, by the Interstate Commerce Act (49 U. S. Code, sec. 20a (12)); with respect to banks, by the Banking Act of 1935 (12 U. S. Code, sec. 78); with respect to competing corporations, by the Clayton Act (15 U. S. Code, sec. 19); and with respect to public utilities, by the Public Utility Holding Company Act (15 U. S. Code, sec. 79q (c)). Although it has been asserted that the prohibitions of section 10 will make most financiers ineligible as directors of investment trusts, that is by no means the case. If, for example, an investment trust owns shares of United States Steel, section 10 (e) would prevent the same investment banker from acting as a director of both the Steel Corporation and of the trust, but it would not prevent a partner in the investment banking house, other than the Steel director, from acting as director of the trust. Subsection (f) would, under those circumstances, prevent the principal underwriting house for United States Steel from having a director on the investment trust board, but the prohibition is applicable only to the principal underwriter and not to other members of an underwriting syndicate.

Section 17 of the bill, prohibiting officers and directors of investment trusts to sell to it or buy from it or borrow from it, is designed to prevent so far as possible what experience proves to have been one of the principal abuses in the investment trust industry. Here, again, there are a number of Congressional precedents for such legislation, notably section 10 of the Clayton Act, which, while it relates to transactions between common carriers and other companies having interlocking personnel with the carriers, nevertheless involves the same fundamental considerations (15 U. S. Code, sec. 20).

On the other hand, the bill wisely makes no attempt to limit managerial discretion as to the investment policy to be pursued, except by forbidding a few obviously undesirable practices, such as purchases on margin and the loaning of money to individuals. It does provide that the trust shall describe in its registration statement the investment policies which are intended to be followed and that it shall adhere to those policies unless the shareholders vote to change them

(secs. 4, 5, 8, and 13). It has happened far too often in the past that investors have put their money in an investment trust in reliance on representations that the trust assets would be invested in widely divesified and liquid securities, only to discover later that their money has been used for the purchase of control of a particular company, for participation in underwriting, or for the purchase of extremely unliquid assets.

The provisions as to capital structure, particularly the prohibition of future preferred stock issues, have aroused some criticism. Why, it is asked, should investment trusts be forbidden a capital structure which is permissible for industrial corporations? The answer is that, since the assets of investment trusts are invested almost exclusively in common stocks, preferred stock of an investment trust represents merely a limited interest in a pool of common stocks of widely fluctuating value. Statistical studies indicate that investment trust portfolios do not on the average behave in a substantially different manner from average prices of listed stocks, which means that in periods of falling common-stock prices, investment trust portfolios tend to shrink rapidly in asset value. Moreover, the same statistical studies demonstrate that, even where common-stock prices are substantially stable, it is difficult for an investment trust to earn its full preferred dividend which can, generally speaking, be earned only if common stock prices are advancing so that the trust is in a position to make capital gains.

As a result of this situation, most existing investment trusts which have substantial preferred stock issues have found themselves at some period of their history in a situation in which preferred dividends were in arrears and the total assets of the trust were insufficient or barely sufficient to cover the preferred-stock holders' liquidation preferences. In 1931 and 1932, nearly all investment trusts which had preferred-stock issues were in this position, and a very large percentage of them are still in that position. (See Securities Exchange Commission Investment Trust Report, pt. 2, p. 816.)

Under such circumstances, the common-share holders, despite the fact that their equity in the assets has been wiped out, so that the entire pool of securities held by the trust would be distributable to the preferred shareholders if the trust were liquidated, usually remain in voting control of the trust. Since their prospects of obtaining dividends are exceedingly remote, they are, in this situation, tempted to seek to profit from their control in other ways—ways which are highly detrimental to the interests of the preferred-stock holders. As I shall indicate in more detail below, the tendency has been in such circumstances for the controlling common-stock holders of investment trusts to capitalize on the value of their control in one of several ways: By speculating with the preferred-stock holders' money in an effort to recoup losses, by selling their control to undesirable persons, or by putting through a recapitalization plan by which the priorities of the preferred-stock holders are drastically reduced.

Provisions for a transfer of voting control to the preferred-stock holders in case of default in the payment of preferred dividends are a very imperfect cure for this situation. The difficulty of organizing scattered preferred-stock holders makes it almost impossible for those stockholders, even where voting control has in theory passed to them, to unite for the purpose of ousting a management which has previously been elected by the common-stock holders; and the danger that directors and officers, who are in reality the representatives of common-stock holders who no longer have any equity in the assets, will manage it in ways which are detrimental to the interests of the preferred-stock holders to whom the assets really belong is, as experience indicates, a very serious one.

Preferred stock which is nothing but a limited interest in a pool of common stock is an anomaly. It can be marketed only in a period of rising security prices and is a dangerous investment except on the unwarranted assumption that the period of rising security prices will not be followed by a period with a sharply reversed trend. The purpose of issuing it is to create leverage for the common stock—a purpose which cannot be accomplished without subjecting the preferred stockholders to risks which they do not anticipate—to the risk that when security prices decline, their theoretical priorities will prove to be no real protection to them.

Since, however, existing preferred stock issues will still exist, the problem of protecting the holders of this class of stock is one which must be given due consideration.

Where common stock retains voting control, despite the fact that it represents no assets, the holders of a controlling interest in such stock, despairing of dividends, are under a strong temptation to sell it to anyone who desires to obtain

control, without the sellers' concerning themselves with the motives which induce the buyer to purchase control. Sales of control of investment trusts which are in this kind of financial condition have in many cases resulted in the transfer of control to interests who have proceeded to loot the enterprise. Such interests have in most cases been other investment trusts, and for this and other reasons the bill wisely forbids the purchase of the securities of one investment trust by another (sec. 12).

Where the assets and earnings of an investment trust which has outstanding both preferred and common shares have declined to such an extent that there have been large accruals of preferred dividends and that little or no asset value is left for the common stock, the controlling common stockholders, instead of selling their control to outsiders, have in a large number of cases improved their position at the expense of preferred shareholders by bringing about a recapitalization which results in a drastic scaling down of preferred stockholders' rights. State laws are wholly inadequate to protect the preferred shareholders in such a situation. Many such laws permit a recapitalization without requiring the separate vote of the preferred shareholders as a class—such being the situation, for example, in Delaware—provided the recapitalization is brought about by merger rather than by amendment. Even where a class vote is required, no state statute compels the management to make a full and fair disclosure to the preferred shareholders as to the reasons for and consequences of the recapitalization for which they are asked to vote; and the proxy rules established by the Securities and Exchange Commission are inapplicable unless the stock is listed on an exchange. Moreover, regardless of disclosure, in many situations the common stockholders are in a position to extort unfair concessions from the preferred by refusing to consent to corporate changes which are in the interest of both groups unless the preferred stockholders will pay for such consent by scaling down their rights. Thus the "nuisance value" of worthless common stock, which the Supreme Court condemned in the *Los Angeles Lumber Products Co. case*, where stockholders of an insolvent corporation attempted to use it to scale down bondholders' claims, may be used to scale down preferred shareholders' priorities in reorganizations which do not involve creditors but only two or more classes of stockholders. Such reorganizations or recapitalizations take place out of court; and although they can in theory be attacked by dissenting stockholders if they are fraudulent, the State courts have so defined fraud as to permit an impairment of preferred stockholders' rights which the Federal courts would not tolerate in a case which came within the Federal bankruptcy jurisdiction.

These glaring defects in the State laws which govern recapitalization abundantly justify section 25 of the bill, which gives the Securities and Exchange Commission power to veto plans which it finds not to be fair and equitable. The section might perhaps be amended so as to exclude judicially supervised reorganizations under the Federal Bankruptcy Act.

Another type of serious abuses are those relating to management contracts. Despite the fact that the only justification for such contracts is to enable a trust to get the benefit of the services of a particular person or organization which is supposed to possess expertness, management contracts have been treated as assignable and have been bought and sold like so much merchandise. Section 15 forbids this practice and also forbids the making of the long-term management contracts which experience has indicated to be undesirable.

State dividend laws, and notably those of Delaware, which is the favorite State in which to incorporate investment trusts, are extremely lax. The Delaware law permits the payment of dividends out of unearned surplus, which are in substance dividends in partial liquidation, without any warning to shareholders that the dividends which they are receiving are unearned. That law, as generally interpreted by the bar, also permits the payment of dividends on common stock out of any kind of surplus, without regard to whether the remaining assets are sufficient to give adequate protection to the preferred shareholders' preferences in earnings and assets. The need of some such provision as that contained in section 19 of the bill is, therefore, obvious.

Neither effective control of corporate dividends nor intelligible publicity of corporate accounts is possible unless those accounts are kept in accordance with sound accounting principles. The majority of existing investment trusts are subject neither to the Securities Act nor to the Securities Exchange Act. The result is that there is neither any legal control over their accounting methods nor any requirement that their balance sheets or income statements be made public. Section 30 of the bill, relating to periodic reports, and section 31, relating to accounts and accounting principles, are designed to remedy this situation—a situation for which a remedy is a vital necessity.

Another valuable provision of the bill is that of section 33, which gives the Securities Exchange Commission the power and duty to investigate proposed settlements of suits against the management for official misconduct, and to make an advisory report to the court concerning the fairness of such settlements. Suits of this kind are ordinarily brought against the management by minority shareholders suing on behalf of the corporation. In such cases, the defendants are, of course, interested in settling the case as cheaply as possible, while the plaintiff and his lawyer are too often interested in settling on terms which are advantageous to them personally, with little or no regard to the interests of the corporation. Under these circumstances, there is no one in court who is genuinely interested in the welfare of the corporation, and the judge is often without adequate means of determining the fairness of a proposed settlement. This situation is one in which a report by an administrative commission which possesses investigatory powers and an adequate staff for making such investigations would be of great value. This whole matter of stockholders' suits and their settlement is one of the notoriously weak spots in our existing corporation law, and section 33 is a decided advance over existing practices.

I have discussed those sections of the bill which seem to me to be the most important and the most salutary. A word in closing as to the bill as a whole. It deals with an industry in which, owing to the liquidity of the assets, misuse of shareholders' funds is peculiarly easy to accomplish. It deals with an industry the primary function of which is to serve as a medium for the investment of the savings of the small investor, the type of investor who can least afford to lose his investment and is least able to protect himself. It deals with an industry in which, owing to the extent to which it has been managed by persons in the security-selling business, self-dealing has been widely prevalent, just as it would be in the railroad and coal industries if railroads were controlled by coal companies or if publicly financed coal companies were controlled by railroads.

The industry is, thus, one which needs regulation, and all of the regulations which are proposed are aimed at evils which have been proved to exist. The regulations go no further than is required to cure the evils; in fact it may be questioned whether some of them go far enough. The bill has been thought by some to confer an undesirable amount of discretionary power on the Commission, but a bill which did not confer a substantial amount of discretion would prove in practice to be unduly rigid. A careful study of the bill will show that a very large part—probably the larger part—of the discretionary powers conferred are powers to grant exemptions from restrictions which, although generally desirable, may operate with unnecessary harshness in some unusual situation. The elimination of discretionary powers of that sort would make the act not only more rigid but more severe.

Senator WAGNER (chairman of the subcommittee). Then, Senators, we can adjourn until tomorrow at 10.30.

Senator HERRING. Yes; fine.

Senator HUGHES. Mr. Sholley's statement is a part of the record, then.

The committee will hear the S. E. C. tomorrow, and will adjourn until half-past ten tomorrow morning.

(Thereupon, at 12:15 p. m., an adjournment was taken until tomorrow, Wednesday, April 24, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

WEDNESDAY, APRIL 24, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, Townsend, and Taft.

Senator Wagner. The subcommittee will come to order. We will proceed, Mr. Smith.

ADDITIONAL STATEMENT OF L. M. C. SMITH, ASSOCIATE COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Smith. During the course of these hearings, Senator Downey raised the question as to the extent of the losses in investment companies which were due to looting and mismanagement, asking whether it was possible to determine how much out of the $3,000,000,000 of capital shrinkage was attributable to such causes.

The calculation of such a figure is at the best an estimate and subject to various limitations which must be obvious. However, we have attempted to make such an estimate.

So that you may know not only the sources of our estimate but have the background to determine whether or not we have merely presented a few rare and horrible examples, as various witnesses would have you believe, I am going to present some over-all facts about what happened to a large section of the industry.

Out of roughly 850 investment companies—and I am excluding other types for the purpose of this discussion—which had been organized up to the end of 1935, over 50 percent, or about 460 companies, ended their individual corporate existence.

At least 61 investment companies had by the end of 1935 gone into receivership or bankruptcy, and this number is greater if later years are taken into account.

Senator Townsend. Do you mean that the figure 850 represents the total of the companies?

Mr. Smith. The 850 represents approximately the total of the management investment companies. I mean the type like—well, this general group that has been here before you.

Senator Townsend. Then you were speaking of the total number of companies.

Mr. SMITH. That is correct. Now, that figure does not include fixed trusts or face amount companies on the installment plan. The total figure would be something like around 1,200 if you include them. I am now talking about the principal type of management investment companies.

Senator TOWNSEND. Then you are talking about over two-thirds of the total companies.

Mr. SMITH. When speaking of the 850 companies that is correct, sir. I am now trying to discuss what happened to those 850 companies.

Senator TOWNSEND. All right.

Mr. SMITH. As I have said, at least 61 investment companies had by the end of 1935 gone into receivership or bankruptcy, and that this number is greater if later years are taken into account.

Some 200 more investment companies were liquidated or dissolved—a number of these probably went into receivership or bankruptcy—with about one-half of these 200 liquidations or dissolutions occurring during 1930 to 1932. These were 3 years of very low security prices, and indicate in the main a disastrous ending to the investors' funds in these companies.

That the management of these 200 companies may not have fulfilled their obligations is witnessed by the fact that, despite efforts on our part, we have not been able to get adequate data on many of these companies or determine in many instances just what happened to the funds of these companies. We only know as to a number that they had so much in funds when organized or at a year-end and that they disappeared.

Finally, another 200 companies were merged or consolidated with other companies. The numerous examples of mergers and consolidations in the 500 pages of stories contained in chapter 4, Part III, of our report, shows that many of the mergers and consolidations were admittedly effected only because of the disastrous record of one or both of the companies involved. I do not say that all of these companies were failures, but there were not a great many that were not.

Now let us look at the losses of these investment companies. The 61 companies mentioned above which went into bankruptcy or receivership by 1935 had a contributed capital of about $500,000,000, of which over $400,000,000 is known to have been lost. It is by no means certain that the losses did not exceed this figure.

I am submitting these companies and the names in table 1.

Senator WAGNER. Will you put that in our record?

Mr. SMITH. Yes, sir; I will put that in the record.

Senator WAGNER (chairman of the subcommittee). That will be made a part of the record by the committee reporter.

(The paper entitled "Table 1, Investment Companies in Receivership or Bankruptcy, 1927–35" is here made a part of the record, as follows:)

TABLE 1.—*Investment companies in receivership or bankruptcy, 1927–35*

[Amounts in thousands of dollars]

Name	Date organized	Date of receivership or bankruptcy	Contributed capital	Repurchases	Contributed capital minus repurchases	Net assets at end of 1935	Capital loss	Remarks
All American Shares Corporation	1929	1932, receivership	1,100		1,100		(1)	A. L. Chambers & Co. exchanged nonliquid securities for portfolio securities.
Allied Capital Corporation	1928	1929, bankruptcy	700		700		700	
American Associated Investors Corporation.	1928	1931, nonpayment of taxes	360		(1)		(1)	Officers disappeared.
American Participations, Inc	1934	1935, bankruptcy	(1)				(1)	
American Utilities and General Corporation (succeeded by American and Dominion Corporation).	1929	1933, receivership	14,739	1,121	13,618	None	13,618	G. E. Barreth & Co., sponsor.
Amherst Shares Corporation	1929	1932, bankruptcy	500			None	500	Amherst National Bank, sponsor, failed.
Anglo-American Holding Corporation	1927	do	2,500				(1)	
Atlantic Midland Corporation	1929	1932, receivership	2,926				(1)	Consolidation of Financial Investment Co. of New York and Domestic & Overseas. Investment Co. Ltd., controlled by Bankstocks Corporation of Md.
Atlantic & Pacific International Corporation.	1928	1935 receivership	6,798		6,798	349	(1)	
Bankers Holding Trust, Inc	1924	1932, receivership	(1)					
Bancscrip Investment Corporation	1929	1930, forced to liquidate	876					
Bankshares Corporation of the United States.	1928	1930, receivership	1,709				(1)	President sent to penitentiary.
Bankstocks Corporation of Maryland	1925	do	2,249				(1)	
Boardwalk Securities Corporation	1925	1934, receivership	950	100	850		(1)	Boardwalk National Bank, sponsor.
Chippewa Share Corporation	1929	1930, consolidated	[3] 329				(1)	Officers sent to prison, Burns, Smith & Co. Inc., sponsor.
City Financial Corporation	1927	1931, bankruptcy	(1)				(1)	
City Shareholders, Inc	1929	1935, receivership	[4] 849		849		(1)	
Consumers Securities Co., Inc	(1)	1933, receivership	(1)				(1)	
Continental Shares, Inc	1926	do	111,108	9,719	101,389	3,204	98,185	
Corporation Securities Co. of Chicago and Insull Utility Investments, Inc.	1929	1932, bankruptcy	229,363	13,742	215,621	4,611	211,010	After intercompany adjustments.
Eastern Bankers Corporation, Bankers Financial Trust, Bankers Capital Corporation, American Fiduciary Corporation, and Bankers Capital Co. of Connecticut.	1922	1931, receivership	[5] 4,154		4,154	None	4,154	R. H. Grender Group.

See footnotes at end of table.

TABLE 1.—*Investment companies in receivership or bankruptcy, 1927–35*—Continued

[Amounts in thousands of dollars]

Name	Date organized	Date of receivership or bankruptcy	Contributed capital	Repurchases	Contributed capital minus repurchases	Net assets at end of 1935	Capital loss	Remarks
Empire Equities Corporation	1929	1931, liquidated on sponsor's failure.	1,200				(1)	E. R. Diggs & Co., sponsor, failed.
Ferguson Participating Trust	1929	1931, receivership	(1)				(1)	
First Cincinnati Corporation	1929	1934 (?)	[6] 2,125		2,125	500	1,625	Estimated.
First Holding & Trading Corporation	1928	1931, permanent injunction	(1)				(1)	First Fiscal Corporation of New York, sponsor.
First International Securities Corporation	(1)	1930, receivership	(1)				(1)	
First Investors Co. of Illinois	1927	1932 (?)	[7] 622		622	None	622	
First Trust Banks Stock Corporation	1926	1931, bankruptcy	1,243		1,243		(1)	
Fiscal Bond & Share Corporation	1929	1931, receivership	1,800				(1)	
Founders Securities Trust	1927	1930, receivership	[8] 1,200		1,200		(1)	
Garard Investment Trust	1929	do	2,534		2,534	None	2,534	Garard Trust Co. (Chicago), sponsor.
General Industrial & Bancshares Corporation.	1929	1930, injunction	3,900				(1)	
Goddard Securities Corporation	1929	1932, bankruptcy	[6] 1,375		1,375	(1)	1,375	Estimated.
Guardian Investment Trust	1927	1931, receivership	[9] 5,703	1,310	4,393	[10] 1,545	2,848	F. E. Kingston & Co., broker, sponsors, bankrupt.
Hambleton Corporation	1929	1932, receivership	7,100	5	7,095	1,311	5,784	
Hytag Financial Corporation	1929	1934, court order	183			46	(1)	
Insurance Equities Corporation	1932	1934, receivership	(1)				(1)	
Knickerbocker National Corporation	1929	1930, bankruptcy	[6] 220		220	None	220	
Metal and Mining Shares, Inc	1928	1930, receivership	5,675	(38)	5,713	None	5,713	C. V. Bob, sponsor, convicted in 1931 of mail fraud in connection with looting of the investment company.
Mosewell Secureties & Bancshares Corporation.	1929	1931, bankruptcy	(1)				(1)	
Municipal Financial Corporation	1927	1930, bankruptcy	(1)				(1)	
National Assets Corporation	1929	1932, receivership	[6] 3,125		3,125	(1)	3,125	Estimated; company enjoined from sale of securities.
National Associated Investors, Inc	1927	1928, receivership	[6] 856		856	57	799	R. H. Watkins & Co., sponsor; convicted of fraud.
National Republic Bancorporation	1930	1933, receivership	(1)				(1)	
New England Collateral Shares Corporation.	1925	1928, bankruptcy	(1)				(1)	
New England Investment Shares	(1)	do	(1)				(1)	
Parker Trading Corporation	1929	1935, receivership	385		385	38	347	C. D. Parker & Co. sponsors.
Penn First National Corporation	1929	1930, receivership	(1)				(1)	
Public Utility Investment Co	1924	1934, receivership	[11] 2,458		2,458	None	2,458	Nathan L. Jones, sponsor; assets pledged for bank loan.
Railroad Shares Corporation	1929	1935, receivership	6,767	1,355	5,412	95	5,317	C. D. Parker & Co., sponsor.
Seaboard Utilities Shares Corporation (Delaware).	1929	do	16,525	260	16,265	271	15,994	Do.

Security Shares, Inc	1927	1932, bankruptcy	1,050		1,050	None	1,050	
Southern National Corporation	1929	1935, receivership	[7] 3,149	424	2,725	[12] 532	2,193	
Standard Shares Holding Co	(1)	——, adjudged insolvent	(1)				(1)	
Stuyvesant National Co., Inc.	1927	1927, bankruptcy	(1)				(1)	
Swedish-American Investment Co	1925	1933 (see remarks)	48,135		48,135	None	17,918	Preferred shareholders exchanged shares for debentures of Kreuger & Toll, which became bankrupt; company repurchased shares from Kreuger & Toll and retired them. Common shares were issued to Ivar Kreuger.
United Hellenic Bank Shares, Inc	1929	1930, injunction, receivership	300				(1)	Hellenic Trading Corporation, sponsor.
United Investment Assurance Trust	1927	1930, receivership	1,571				(1)	
United Investors Corporation	1932	1935, receivership	368		368	249	119	McMurray, Hill & Co., sponsor.
Utilities Hydro & Rails Shares Corporation	1929	do	1,574	56	1,518	51	1,467	C. D. Parker & Co., sponsor.
Web Holding Co.	1926	1931, bankruptcy	767		767	None	767	Share capital only, excluding borrowing.
Total known contributed capital or assets at first year-end.			503,120					
Total known losses							400,442	

[1] Unknown.
[2] Assets, Sept. 30, 1929.
[3] Assets.
[4] Assets, 1929.
[5] Assets, 1928.
[6] Capital.
[7] Capital, 1929.
[8] Assets, 1927.
[9] Paid-in capital, 1931.
[10] May 31, 1935.
[11] Capital, 1931.
[12] Nov. 30, 1935.

Source: Secondary sources and correspondence and field studies.

Senator WAGNER. You may proceed, Mr. Smith.

Mr. SMITH. In my opinion and with my knowledge of the operations of a number of these companies, the greatest part of this loss was due either to looting or faithless management. By the terms "looting" or "faithless management" I mean that the loss was due to a management acting for its own interests either in bad faith or with wanton disregard of the rights of the investors. These are cases of maladministration.

The 200 companies mentioned above which had dissolved or liquidated, had almost as bad a record as the 61 companies, with relatively few exceptions. These companies had about $200,000,000 of contributed capital and the greatest part of this is estimated to have been lost based on the testings that we were able to make.

In this connection I am putting into the record a more detailed study of 148 investment companies which failed to respond to our questionnaire (and the most of them had an unfortunate ending) and which raised $700,000,000 of capital and had a loss ratio of 86 percent and 90 percent and over. These 148 companies in this more detailed study overlap some of the other companies mentioned here. However, the study may be of aid in understanding the extent of the losses in the industry. I will put this in your record.

Senator WAGNER. All right. The committee reporter will make that a part of the record.

(The memorandum entitled "General Management Investment Trusts and Investment Companies Which Did Not File Either Questionnaires or Summary Statements and so forth" is here made a part of the record, as follows:)

GENERAL MANAGEMENT INVESTMENT TRUSTS AND INVESTMENT COMPANIES WHICH DID NOT FILE EITHER QUESTIONNAIRES OR SUMMARY STATEMENTS BECAUSE SUCH COMPANIES WERE LIQUIDATED BY DECEMBER 31, 1935, WERE IN THE PROCESS OF LIQUIDATION, OR FOR SOME OTHER REASON FAILED TO FILE OR WERE EXCUSED

INTRODUCTION

Of the 814 general management investment trusts and investment companies to which the Commission directed questionnaires or summary statements for preparation and filing in connection with its study, 130 failed to respond. These had been liquidated or were in the process of liquidation by December 31, 1935. To this group has been added 18 more companies of similar character and status but to which neither questionnaire nor summary statement had been sent, increasing the number of companies falling within the scope of this chapter to a total of 148.

The reasons underlying failures of these companies to file, or for individuals formerly responsible for their management to file for them, were various and in general not unattainable. It was frequently found that during the interim between the date at which a company had been liquidated and the date upon which the questionnaire was sent out, former officials had moved on to other addresses and could not be conveniently located, or, if located, were no longer in possession of records containing the information desired. In cases of companies which had been placed in receivership or bankruptcy, trustees often asked to be relieved of responsibility in the matter on the grounds that they had no staff, nor funds with which to employ a staff, capable of assembling the data. In still other instances, individuals to whom inquiries were addressed simply ignored the inquiry or responded in a noninformative manner.

It was hoped originally to present in this memorandum a complete and accurate over-all picture of the performance of these 148 companies as a group, but with information regarding one phase or another of some of the companies lacking, as it developed, the composite figures and datum must of necessity also be incomplete.

Notwithstanding deficiencies in this respect, which will be pointed out as the memorandum progresses, a sufficiently comprehensive summary has been constructed so as to provide a reasonable approximation of the experience and salient corporate features of that section of the industry which has definitely passed out of existence. The factual matter upon which this summary is based was obtained from the following sources:

1. Field examinations of the books and records of a limited number of companies.
2. Former officials of the companies or firms with which they had been associated.
3. Receivers and trustees in bankruptcy.
4. Moody's Manual.
5. Poor's Manual.
6. Keane's Manual of Investment Trusts.
7. The state departments of several of the States.

With this material at hand the 148 companies were categorized according to the completeness of the information available with respect to each. Segregation was made on the following bases:

	Number of companies
1. Companies regarding which substantial information was obtained through brief field studies conducted by the Commission staff	7
2. Companies regarding which limited information was obtained through the examination of available balance sheets and supplemented with data obtained from reference books or supplied by persons formerly connected with the particular company	[1] 68
3. Companies regarding which the information available consists only of the number of shares offered for sale, or, in some instances, outstanding, and the offering price	41
4. Companies regarding which only meager statistical information was available	32
Total	148

[1] Includes Insull Utility Investments, Inc., and Corporation Securities Co. of Chicago.

Field examinations enabled the Commission's staff to obtain accurately the amount of capital contributed to the seven companies included in first group, while the amount of capital shown as contributed to companies included in second group is based in most instances upon the maximum amount of capital shown as paid in as of dates at which balance sheets could be found. No balance sheets were available with respect to companies included in group three. The amount of capital shown as contributed to these is therefore based upon the number of shares offered for sale by each company (as indicated by financial manuals, circulars, etc.), or outstanding where determinable, at the offering price. No figure at all could be found with respect to the 32 companies included in the fourth group.

Therefore, when the terms "net contributed capital" paid into these companies is used or when any other use of the word "capital" is made, it should be borne in mind that these figures are limited in accuracy to the extent that information was available, as described in the foregoing paragraphs, and serve merely to give the reader some idea of the amounts involved.

CONTRIBUTED CAPITAL

For the most part, this group of 148 companies, numerically comprising nearly 18 percent of the total of 832 general management companies included in the Commission's study, present a picture of that section of the industry which was paled into relative obscurity by the overshadowing size and popularity of their better-known contemporaries. Of diverse corporate characteristics and size, predicated upon a variety of ideas, experiencing different degrees of success or failure, they possess one feature in common. All are permanently out of existence, and the former owners are left with comparatively negligible, if any, hope of recouping any part of their huge loss through future improvement in business conditions, an anticipation remaining to the security holders of surviving companies.

Upon the bases of computation already explained, a total of $696,714,143.07 share and borrowed capital was paid into 116 companies in the proportions shown on table 1 which follows:

TABLE 1.—*Contributed capital*

Group	Number of companies	Preferred share capital	Common share capital	Paid-in or capital surplus	Total share capital	Borrowed capital	Total capital contributed
1	7	$6, 882, 912. 00	$40, 915, 777. 52		$47, 798, 689. 52		$47, 798, 689. 52
2	68	123, 953, 464. 25	232, 943, 572. 28	$61, 845, 023. 57	418, 742, 060. 10	$154,394,593.55	573, 136, 653. 65
3	41	21, 409, 725. 00	54, 369, 075. 00		75, 778, 800. 00		75, 778, 800. 00
4	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Total	116	152, 246, 101. 25	328, 228, 424. 80	61, 845, 023. 57	542, 319, 549. 62	154, 394, 593. 55	696, 714, 143. 17

[1] Figures not available.

If figures with respect to the 32 companies included in group 4 were available this aggregate would, of course, be increased substantially. Moreover, the figures shown on table 1 represent only the amount which was actually paid into the 116 companies involved (on the three bases indicated) and does not reflect any differential between the amounts that the companies received and the amounts paid by the public to the distributors. This may have been considerable for it is definitely known that in keeping with the widespread practice of the time, some of these companies sold their capital securities to a distributor who then ran up the market and disposed of them to the public at greatly increased prices.

Reference to table 1 will disclose that of the total of $696,714,143.17 capital contributed to these 116 companies, $390,073,448.37, or 56 percent was raised through sale of common shares. Capital or paid-in surplus has been added to common share capital here since practically all of this surplus appears to have been paid in on this class of shares. Preferred share capital represents 22 percent of the total and borrowed capital 22 percent.

It was observed in the course of assembling data regarding this group of companies, that many had two classes of common shares outstanding, designated generally as class A and class B, in one of which resposed full or special voting privileges. While more precise information with respect to this practice is lacking, the assumption that these special voting shares were acquired and held by those identified with the organization and management of the companies is not illogical. Thus, many common-stock holders surrendered complete control over their funds to an infinitesimally smaller group whose financial contribution to the common fund was much less.

Still another practice observed to have been indulged in, in a few instances, was the issuance of common "founders" or "managers" shares to the sponsors and managers of the companies. In the light of the limited information at hand, these appeared to be identical in all respects to the other common shares except that they were bestowed free upon the recipients or sold to them at nominal prices.

In groups 1 and 2, included in the preceding table, there is an aggregate of 75 companies, 11 of which borrowed capital funds to the extent of $154,394,593.55. There were also three additional companies that are known to have borrowed heavily in aggregate, but the amounts could not be accurately determined. No figures at all were available with respect to the borrowing of the 73 companies in cluded in groups 3 and4.

There has been included in the total of $154,394,593.55 borrowed capital not only funds raised through bond issues but also loans made from banks and retained by the companies for so long a time—generally a period of years covering the greater part of the company's existence—that, in effect, it became permanent capital. It is not represented here that this figure reflects all of the money borrowed by this group for loans made and repaid within a short time have been purposely omitted as not constituting permanent capital. Moreover, funds may have been borrowed after the date of the last available balance sheet.

Further analysis discloses that of the total borrowed capital shown to be $154,394,593.55, $147,201,678.76 was owed by the two Insull companies, Insull Utility Investments and Corporation Securities Co. of Chicago, leaving only $7,192,914.79 borrowed by nine companies. While the loss suffered by the banks from which the two Insull companies borrowed is known to have been a large

percentage of the total, the exact amount cannot be determined since the banks retained the collateral. Some of the other nine companies went into receivership and others were voluntarily liquidated.

To summarize, a large number of security and note holders contributed an aggregate amount of $696,714,143.17 capital (on the 3 bases indicated in the opening paragraphs of this chapter) to 116 general management investment trusts and investment companies. Of this total capital, $458,240,626.34 was contributed to four companies which in point of size completely overshadowed the others. These are shown on table 2 which follows:

TABLE 2.—*Gross capital contributed*

Name of company:	
Insull Utility Investments, Inc	$249, 508, 037. 84
Corporation Securities Co. of Chicago	130, 909, 707. 23
Bankus Corporation	29, 688, 081. 27
Swedish American Investment Corporation	48, 134, 800. 00
Total	458, 240, 626. 34

By deducting the capital contributed to the 4 companies shown in table 2 from the aggregate, it is found that the remainder, amounting to $238,473,516.83, was paid in to 112 companies, or an average of $2,129,227.82 to each.

During the course of assembling this information, effort was made to determine how much of this aggregate contributed capital was returned to shareholders thorugh repurchases of their shares by the company. In the cases of the 41 companies included in group 3, for which no balance sheets could be found, this figure could not be determined. However, through examination of the books of the 7 companies included in group 1 and by tracing through the outstanding capital shares, and capital and capital surplus accounts of the 68 companies included in group 2, a reasonably accurate figure was arrived at in most instances. This amounted to $59,231,725.98, which, if deducted from the gross contributed capital of $696,714,143.17, leaves a net amount of $637,482,417.19. From this a further deduction of $3,407,086.27 has been made with respect to the 7 companies included as group 3, consisting of the excess of dividends paid to stockholders plus distributing and organization expenses over interest and dividends collected. This information was available only in these 7 instances and leaves a net contributed capital to be account for the 116 companies amounting to $634,075,330.92.

LIQUIDATION

It has already been pointed out that all 148 companies under discussion in this memorandum were either liquidated or in the process of liquidation at December 31, 1935. Herein lies an important distinction between this group and those companies which remained active. The security holders of companies still in existence, regardless of how great their present unrealized capital loss may be, or how shattered their confidence in the management of their particular company or the investment trust theory generally, are in a position with honest and competent management to recoup at least a portion of their losses as security prices and general business conditions improve. The large number of investors in these 148 companies, however, have already sustained a definite irreparable loss. Many of these, no doubt, were forced out of their investment via the bankruptcy courts just when security prices were at their lowest levels, or by panic-stricken managements that urged premature voluntary liquidation.

Because of the great amount of time and field work which would be required to determine the net worth remaining for security holders in all of these companies at dates of termination, residual values have only been obtained in a sufficient number of instances to provide a basis for computing a reasonable estimate for the group.

It has already been pointed out that of the total of 148 companies under consideration, no figures whatever were obtainable with respect to the 32 included in group 4, leaving 116 companies into which was paid the $634,075,330.92 net aggregate capital previously discussed. Of these, the residual values of 64 companies was not determined. A total of $513,780,377.32 net capital had been paid into the remaining 52. Upon liquidation, or at the dates of receivership, in the few cases where liquidation has not yet been completed, there remained an estimated residual value of $68,584,705.14 in these 52 companies, indicating a capital loss of $445,195,672.18, or 86½ percent of the net contributed capital.

Further analysis discloses that in the entire group upon which reasonably accurate information was available that there were but 8 companies voluntarily liquidating which completed such liquidation without a loss to their stockholders.

After eliminating these 8 companies from the total of 52, and also eliminating Insull Utility Investments, Inc., Corporation Securities Co. of Chicago, Swedish American Investment Co. and Bankus Corporation with its two absorbed companies, City Financial Corporation and Municipal Financial Corporation, which if included, would distort a representative picture because of their relative magnitude, it is found that 38 companies remain. To these 38 had been contributed an aggregate of $89,878,769 net capital. It is estimated that at their termination there remained a residual value of approximately $10,901,945.88, indicating a capital loss of $78,976,823.12, or 90 percent of the net contributed capital.

It is believed that this 90 percent capital loss in 38 companies can be accepted as a very conservative indication of the loss sustained by the entire group of 148, and, that if more complete information was available with respect to the other 110 companies, an upward rather than a downward revision of this figure would result.

HOW TERMINATED

Every effort was made in preparing this chapter to determine how the 148 companies composing this group went out of existence. Obstacles already cited frustrated complete success in this direction, although again it is believed that a fairly elucidating cross-section picture has been produced. The cessation of the activities of 107 of the 148 companies may be summarized under the following general categories:

TABLE 3.—*Number of companies*

Bankruptcy	24
Receivership	19
Dissolution	47
Forfeiture of charter for nonpayment of taxes, etc	4
Enjoined from sales of capital securities	7
Dissolved by proclamation of the Secretary of State	1
Charter expired	1
Inactive	4
Total	107
Not known	41
Total	148

With a few brief words of explanation, the foregoing facts speak eloquently for themselves without further comment. Because of a dearth of specific information, it was impossible to determine how many of the 47 companies listed merely as having been "dissolved" were dissolved voluntarily and how many involuntarily. It is quite possible that some of these actually belong under the heading of "receivership" or "bankruptcy," but because of a lack of precision in terminology used by financial manuals or individuals supplying information, the real facts have been obscured. Likewise, there is little doubt that while the term "dissolved" or "voluntarily dissolved" describes the demise of some companies with technical accuracy, they were in fact forced into liquidation, without resorting to formal court procedure, by reason of their precarious financial condition or helpless inability to continue operations with profit.

Table 3 also shows that there were 41 companies out of the total of 148 regarding which no information at all could be found with respect to the manner in which they were terminated. In view of the circumstances under which the other 107 were liquidated, however, it is not unreasonable to assume that a substantial proportion of these companies met with similar fates.

Therefore, it becomes apparent that, with the exception of the 8 companies which liquidated without capital losses, most of the entire 148 companies were forced to liquidate. Moreover, it is definitely known that those companies whose contributed capital comprises the great bulk of the $634,075,330.92 aggregate were placed in bankruptcy or receivership.

SPONSORS

The study conducted of the group disclosed that these companies were conceived and launched by a variety of individuals, firms, and institutions. Table 4, which immediately follows and is based upon information available, classifies these sponsors.

TABLE 4.—*Classification of sponsors*

	Number of companies	Percent of total
1. Companies known to have been sponsored by brokers, dealers, distributors, and/or investment bankers	36	25
2. Companies the sponsors of which are not definitely known but which appear to have been sponsored by brokers, dealers, distributors, and/or investment bankers since their capital securities were distributed through one of these media	17	12
3. Companies sponsored by other investment companies or organizations functioning as managers or fiscal agents of investment trusts	12	8
4. Companies sponsored by commercial banks	15	10
5. Companies sponsored by investment counsellors	3	2
6. Companies sponsored by organizations engaged in extraneous lines of business	2	1
7. Companies sponsored, or believed to have been sponsored, by private individuals or groups of private individuals	39	26
Total	124	84
8. Sponsorship not determined	24	16
Total	148	100

According to table 4, 85, or 58 percent numerically, of the total 148 companies were sponsored by firms engaged in one phase or another of the security business, commercial banks, or investment counsellors; the sponsorship of 24 companies was not determined; and, the remaining 39 companies, or 26 percent of the total, had for their sponsors private individuals or groups of individuals who are not specifically known to have been identified with nor to have represented interests falling within one of the other classifications. If more complete information were available with respect to the identity and business affiliations of all of these individuals it might be necessary to shift some of these 39 companies to other categories. However, the change would not be material.

Further examination of table 4 reveals that 36, or 25 percent, of the 148 companies are known to have been sponsored by broker, security dealers and distributors, and investment bankers. Sponsors of one-third of these 36 companies are identified as having been members of the following stock exchanges:

Name of stock exchange:	*Number of sponsors*
New York	9
Philadelphia	1
Buffalo	1
Portland, Oreg.	1
Total	12

Still other sponsors were found to have been members of the Investment Bankers Association of America and the Security Dealers Association.

Table 4 also shows that circumstances indicate that the sponsors of 17 more companies were firms operating as brokers, dealers, distributors, or investment bankers. Assuming these circumstances to be true indications of fact, the number of sponsors coming within this classification would then be 53, or 37 percent of the total.

The foregoing table shows further that 12 of the 148 companies were sponsored by other investment trusts or firms functioning as managers or fiscal agents for investment trusts, and that 15, or 10 percent of the total had for their sponsors commercial banks.

The experience of bank-sponsored or affiliated trusts included in this section of the Commission's report appears to have been almost uniformly disastrous. Of the nine regarding which sufficient information is available to permit tabulation,

eight culminated in receivership or bankruptcy. These are shown in table 5 which follows:

TABLE 5.—*Bank-sponsored or affiliated companies which terminated in receivership or bankruptcy*

Name of trust	Sponsor or affiliated bank	How terminated
Amherst Share Corporation	Amherst National Bank, Williamsville, N. Y.	Bankruptcy.
Bancscrip Investment Corporation	Roosevelt State Bank, Chicago, Ill	Forced to liquidate.[1]
Boardwalk Securities Corporation	Boardwalk National Bank, Atlantic City, N. J.	Receivership.
Bankus Corporation	Bank of the United States, New York, N. Y.	Do.
City Shareholders, Inc	City Trust Co., Indianapolis, Ind	Do.
Commercial Share Corporation	Commercial Trust Co., Buffalo, N. Y	Do.
Garard Investment Trust	Garard Trust Co., Chicago, Ill	Bankruptcy.
Web Holding Corporation	World Exchange Bank, New York, N. Y.	Do.

[1] Forced to liquidate after president of bank was committed to penitentiary.

An outstanding exception is found in the ninth bank-sponsored trust. This was the United States Securities Investment Co. which was organized by the United States Trust Co., Newark, N. J., operated by L. F. Rothschild & Co., jointly with the bank, and liquidated with a small capital appreciation after having weathered the 1929 market decline and paid dividends consistently.

In a few instances, at least, the causes of the failures of the eight companies shown on table 5 are traceable directly to their affiliations with the banks. Two of the companies had invested heavily in the stock of the banks with which they were associated. When the banks failed, the double liability feature inherent in bank shares was too great a burden for the trust and bankruptcy resulted. In at least one other case it is definitely known that the temptation to exchange frozen assets of the bank for the liquid portfolio in the trust proved too irresistible an expedient for the directors of tottering banks. When these frozen assets failed to thaw over a period of time, the trust was left with no alternative but receivership.

In a few instances, notably the Bankus Corporation (affiliate of the Bank of United States) and the two companies it absorbed, Municipal Financial Corporation and City Financial Corporation, the certificate of interest in the investment trust was attached to or stamped upon the stock certificate of the bank. While some of the bank-sponsored investment companies took the form of an investment trust (investing a substantial portion of its capital in a diversified list of securities), the Bankus Corporation group appears to have been a combination holding company and underwriter. Its principal holding was stock of the Bank of United States. In some cases, the shares of the trust were offered publicly and in others admittedly sold to depositors of the sponsor bank.

ORGANIZATION AND LOCATION OF PRINCIPAL OFFICES

It was found that the corporate form of organization overwhelmingly predominated over any other in the choices of the organizers of these companies. Information concerning form of organization is lacking in only 6 instances. Of the remaining 142 companies, 131 were incorporated. Ten of the other 11 were common law trusts organized in the following States:

	Number of companies
Massachusetts	6
New York	1
Indiana	1
Illinois	1
California	1
Total	10

The eleventh company was created by a special act of the Legislature of the State of Connecticut and is difficult to classify.

Table 6, designed to show the number of companies which were domiciled outside of the States in which they were organized, presents an interesting study.

TABLE 6.—*States in which organized and location of principal offices*

	Number of companies—State of organization	Number of companies—Location of principal office
Delaware	66	
New York	26	72
Massachusetts	11	12
Maryland	6	
Connecticut	4	4
Illinois	5	6
New Jersey	3	13
Indiana	2	1
Washington	2	2
Nevada	2	
Oregon	1	2
Iowa	1	3
Ohio	1	1
California	1	3
Kentucky, Kansas, Michigan	3	2
Missouri, District of Columbia, Pennsylvania		5
Not known	14	22
Total	148	148

Of the total of 148 companies under consideration, the States of organization could not be determined in 14 instances. The remaining 132 companies were organized in 17 different States, and, while 66, or about half, were organized in the State of Delaware, not a single one operated in that State. The table also shows that while New York was the next popular State for organizing these companies, with 26 companies organized under its laws, 72 maintained their principal offices within its borders.

Massachusetts ranked third in point of companies organized under its laws with 11 companies organized and about an equal number also maintaining their principal offices there. However, it is to be remembered that 6 of these 11 companies were Massachusetts common law trusts and were not created under the corporation laws. There were 6 companies organized in Maryland with none operating there and while only 3 companies were organized under the laws of the State of New Jersey, 13 maintained their principal offices in this State.

In summary, the statistics concerning this group of companies merely serves to confirm what is known to be true with respect to the entire industry, that the corporation laws of the States of Delaware, New York, and Maryland are best adapted to the organization of investment trusts and companies; that New York and New Jersey, because of their proximity to the world's most important financial center, and, in the case of New Jersey, because of favorable tax laws as well, are the most popular seats of operation; and that Massachusetts leads in point of number of common law trusts.

Table 7, which follows, presents a more specific tabulation of the locations of the principal offices of 126 of the 148 companies. This table examined in conjunction with table 6 discloses that of the 72 companies domiciled in New York State, 66 were located in New York City, that all of the 12 companies operating in Massachusetts were located in Boston, and that 11 of the 13 companies operating in New Jersey maintained their offices in Jersey City, a few minutes across the Hudson River from New York City. Likewise all 6 companies whose principal offices were in Illinois were located in Chicago. The offices of the remaining companies were scattered throughout 22 cities in nearly every section of the Nation.

TABLE 7.—*Cities in which principal offices were located*

	Number of companies
New York, N. Y	66
Boston, Mass	12
Jersey City, N. J	11
Chicago, Ill	6
Bridgeport, Conn	4
Des Moines, Iowa	3
Portland, Oreg	2
San Francisco, Calif	2
St. Louis, Mo	2

TABEE 7—*Cities in which principal offices were located*—Continued

	Number of companies
Buffalo, N. Y	2
Los Angeles, Calif	1
Newark, N. J	1
Salina, Kans	1
Rochester, N. Y	1
Washington, D. C	1
Louisville, Ky	1
Tacoma, Wash	1
Williamsville, N. Y	1
White Plains, N. Y	1
Cincinnati, Ohio	1
Atlantic City, N. J	1
Mount Vernon, N. Y	1
Indianapolis, Ind	1
Pittsburgh, Pa	1
Philadelphia, Pa	1
Seattle, Wash	1
Not known	22
Total	148

Senator WAGNER. I believe Senator Townsend has a question to ask you.

Senator TOWNSEND. I have not a question particularly, but I would like to call attention to the fact that these companies did not last more than from 1 to 4 years.

Mr. SMITH. Well, sir, I have a list of about 200 companies—and we were not going to put this list into your record unless you want it—but you will notice from this list of companies that were dissolved or liquidated, the great majority of them lasted only a few years, and primarily they were dissolved or liquidated in 1931, 1932, and 1933. Those are the common dates occurring through there, and those are the years of the depression.

Senator WAGNER. You may proceed.

Mr. SMITH. In addition there are about 200 companies which were merged, consolidated, or otherwise acquired by another company during the period 1927–35, mostly in the years 1930–32, which can be seen by our chapter IV. Many, if not most of these companies, can be presumed to have gone out of existence because of mismanagement based upon the known records and testimony as to a large number covered in chapter IV and the investors in these companies undoubtedly suffered large losses as a result of such mismanagement. For example, in the 20 companies (excluding Blue Ridge Corporation) acquired by the Atlas Corporation, there were large losses during the period before the Atlas Corporation acquired them which may be attributed in large measure to their mismanagement prior to being taken over by Atlas.

Similarly, large losses occurred in the companies acquired by the Equity Corporation which companies were in the United Founders Corporation group, and others.

Senator TOWNSEND. Might I make a comment there?

Mr. SMITH. Yes, sir.

Senator TOWNSEND. I have not been here very much due to the fact that I have been engaged on the work of other committees, but I presume you have put in the record a picture of how these companies contributed this capital, haven't you, or have you?

Senator WAGNER. Oh, yes; that has been shown.

Mr. SMITH. Yes, sir.

Senator TOWNSEND. Then I can read the record on that.

Mr. SMITH. May I say, and of course I am speaking now from memory, that about $3,000,000,000 of securities were sold in 1929, which was characteristic, as Professor Dodd pointed out, that securities of these investment companies are sold in periods of high prices, because that is the period when it is easy to sell them.

Senator WAGNER (chairman of the subcommittee). You may proceed.

Mr. SMITH. The contributed capital of the 200 companies which were merged and consolidated with other companies was very great. For instance, the contributed capital of 21 companies in the group taken over by Atlas was close to $500,000,000. It has not been possible to make complete estimates for these 200 companies.

Finally, there were 390 companies that survived to 1935, but among them we find a number of companies with such heavy losses as to justify either an inference of very poor management or mismanagement. Thus out of 38 companies with a contributed capital of $2,772,000,000, $1,800,000,000 was lost. All these companies had losses in excess of 50 percent of their contributed capital at the end of 1935. The stories of many of these companies are covered in detail in various parts of our reports.

Included in these losses were the large losses in companies in the United Founders Corporation group aggregating at least 380 million dollars; in Eastern Utilities Investing Corporation, about 47 million dollars, now in receivership; in Petroleum Corporation over 60 million dollars; in Commonwealth Securities, Inc., about 25 million dollars; in Utility and Industrial Corporation about 33 million dollars; in Liberty Share Corporation about 7 million dollars; in Continental Securities about 5 million dollars; and in Insuranshares Corporation of Delaware, about 4 million dollars.

I have reviewed with other members of the study the various companies we know of and attempted to make an estimate of the losses which were due to looting or maladministration. Because of possible lawsuits to the companies involved and possible unfairness in mentioning their names in such a list, I am not mentioning the specific companies or the amount of losses which we attribute to these improper causes, although I have work sheets which indicate how we make out figures and I am prepared to support them.

I can show this to the subcommittee if you care to see it, but I would prefer not to put it into the record for the reason stated.

Senator TOWNSEND. What is that reason?

Mr. SMITH. I am afraid there might be lawsuits and I think it might be unfair to single out these companies in a hearing like this.

Senator TOWNSEND. I think that is proper.

Senator WAGNER (chairman of the subcommittee). All right, you may go ahead with your statement.

Mr. SMITH. Based on the cases we actually know of we estimate that at least $1,100,000,000 of capital shrinkage in investment companies may be attributable to mismanagement, looting, or improper actions of managements in their own interests to the detriment of shareholders.

Furthermore, this figure is in many instances a conservative figure as I can show by many specific cases and it is possible that it might be as high as $1,500,000,000.

Mr. Motley said the other day he had heard of no testimony as to banks, testimony showing abuses in connection with them. [illegible]ll, in connection with commercial banks, almost every case we [illegible] they had suffered tremendous losses, and people who w[illegible] investment companies, in connection with banks said ther[illegible]e absolute segregation, that there was no reason for them to [illegible] up together. The losses in this particular situation which I have [illegible] here, are about $2,900,000, which is the amount of losses on loa[illegible] to 86 officers and directors for margin accounts, in the stock of the bank and the stock of the investment company. However, in my opinion a large part of the total loss, from $12,000,000 to $623,000, by 1935, was due to these margin accounts by insiders and borrowings by insiders. The Chase National Bank itself lost a million dollars because of that.

I am just trying to show you gentlemen that there are problems involved here, and how we have tried to approach the subject, that we have not gone to the extreme, or tried not to.

This estimate does not take into account how much of the market value shrinkage of the industry from its peak of $8,000,000,000 up through the crash in 1929 to less than $4,000,000 at the end of 1935 was due to malpractice. The figure on losses of course would be much greater than the loss included in contributed capital.

Nor do I wish it to be understood that all of the companies referred to in the above list were guilty of malpractice. Such an estimate is a difficult one to make at best and confidence must be placed in the fairness of the person attempting to make such an estimate.

So that you may realize that the problems we are talking about in these hearings are not isolated specimens but are characteristic of the industry I am going to ask your indulgence to set forth a few of the other complex problems of the industry we are dealing with.

Those chapters of part III of our report already released discuss various abuses in connection with the organization and operation of almost 100 investment companies, with an aggregate contributed capital of $2,250,000,000. That means that in those companies we felt there were problems which we thought should be discussed in connection with the abuses in the problems of regulation of investment companies.

In other sections, about ready for release, we cover cases of about 40 or 50 companies more with similar amounts of contributed capital.

Now, there are certain other figures I would like to put into the record so that the magnitude of the problems we have had to deal with and the wide extent of possible abuses, may be indicated.

Let us take in connection with exchanges: We devoted an entire chapter, of 500 pages, to the problems of exchanges—and Professor Dodd spoke yesterday about the unfair advantages that can be taken by exchanges, and we have numerous instances of it.

Securities issued in connection with mergers and consolidations of closed-end companies (including investment holding companies) had a total value of $873,000,000. In other words, there are $873,000,000 of exchanges. Not all these exchanges but a large part of them, may raise very definitely the question of the fairness of the exchange, of one side getting the better of the other.

Now let us take switches: Of 56 fixed trusts studied, offers of exchange were made for 36, with securities valued at about $92,000,000 exchanged.

Ther [illegible] have the whole problem of the load, which is an indication of the [illegible] connected with the sale of these securities, the reason why [illegible] and why it is profitable to sell them.

[illegible] ata in chapter VII, part II, total underwriting compensation [illegible] ities of closed-end companies may be estimated at about [illegible]; and this "load" does not take account of profits made by [illegible] on the resale to the public of securities issued to them and [illegible] exercise of options.

Total sales to "insiders" (private offerings and sales to bankers, sponsors, and so forth) amounted to $343,000,000 out of aggregate offerings of $2,869,000,000 studied (exclusive of intercompany transactions), and sales resulting from the exercise of options amounted to $32,600,000 in this aggregate.

The "load" in open-end companies amounted to about $37,000,000 (8 percent of the $463,000,000 of sales) and in fixed and semifixed trusts the "load" was about $80,000,000 (8½ percent of aggregate sales of $943,000,000.)

In installment investment plans, the "load" amounted to about $4,000,000 of total sales of about $20,000,000, and in companies issuing face amount certificates the "load" aggregated $41,000,000 in total sales of $161,000,000.

Senator WAGNER. How much was the load there? Did you say $41,000,000?

Mr. SMITH. Yes; $41,000,000. Now, I am just trying to give you some over-all figures on the "load," and I do not think these figures could be related to the total sales.

Senator WAGNER. All right.

Mr. SMITH. Total sales load in all types of investment trusts and companies thus amounted to about $460,000,000 for the period 1927–35 This indicates a possible reason, or one of the main reasons, for the origination of these companies, or the possible desire to form investment companies for the sale of securities as opposed to management companies.

Senator TOWNSEND. How do you define total load?

Mr. SMITH. Well, the load is the difference between the amount paid by the investor and the amount which the investment trust received. It is the amount which is paid to the underwriter and distributor?

Senator TAFT. How much was that?

Mr. SMITH. The total was about $460,000,000.

Senator TAFT. What percentage is that?

Mr. SMITH. Well, the percentage varies in the different types of companies.

Senator TAFT. I have no doubt about that, but the $460,000,000 does not mean anything unless you have the total amount of securities sold.

Mr. SMITH. I think the total sales of all types of investment company securities was something like $7,000,000,000. I am not trying here to show that the load was excessive, but am trying to show it is a substantial amount.

Senator TOWNSEND. That would be about 6 percent, I take it?

Mr. SMITH. That is right. In some cases it is 8 percent, and in some other cases, for instance in the installment investment plan, it went up as high as 18 percent. And if you consider that in the installment investment plans that the load is paid on an average

investment, over a period, of $10 a month instead of $1,000, and the average is $500, the load is much higher.

Senator TAFT. Do you know the limit on that in Ohio? As I understand we have in Ohio an express limit on loads in investment trusts.

Mr. SMITH. I am not familiar with Ohio. I know that in a number of States it is 10 percent.

Senator TAFT. Did you say 10 percent?

Mr. SMITH. Yes.

Senator TOWNSEND. In your experience what would be a reasonable amount for the load?

Mr. SMITH. From my experience I would like to see investment company securities sold at a load of 4 or 5 percent. However, I think there are difficulties in fixing a flat amount because that might become the maximum. That is what I am afraid of.

Senator TOWNSEND. Do you mean that you would like to see them sold on the basis of 4 or 5 percent, and in this case it is 6 percent?

Mr. SMITH. Yes. But we do not attempt to regulate the load unless it is excessive.

Senator TAFT. If a new investment company goes out and sells securities, not just stock-exchange securities but securities connected we will say with some venture, is it 15 percent? It seems to me we have a 15-percent limit in Ohio on promotions.

Mr. SMITH. Will you pardon me for a moment and let me ask someone here?

Senator TAFT. Certainly.

Mr. GOLDSMITH. Well, in recent years, according to registration statistics, bonds and preferred stock were predominant. The rates were very low. But I take it you are talking about common stocks only.

Senator TAFT. Yes.

Mr. GOLDSMITH. In recent years there have been practically no sales of common stock issues of a size comparable to many of the investment company issues. I think it is hard to make a comparison. For small issues of stock, of course, the total selling cost is very high, and as you say it may be 10 percent or 15 percent or perhaps even 20 percent.

Senator TAFT. My impression under the "blue sky" law in Ohio is that it is 15 percent, that that is allowable. That does not mean it ought to be that amount, but I think that is the load.

Mr. SMITH. I think there are a number of States that have 10 percent on investment securities.

Senator WAGNER. We have here a table, have we not, of the load the different companies charge?

Mr. SMITH. That is correct.

Senator WAGNER. I referred to that on yesterday when I asked a question of Mr. White, who represented a very well-run investment trust. They charge no load at all, but that is an exceptional case. I asked him whether 7 or 8 percent would be a reasonable charge and he said "That is getting way up in the higher brackets." He is known as a successful operator.

Mr. SMITH. Certainly investment counsel who do not actually solicit sales are able to have a very low load. They are primarily interested in the management end of the business.

Senator WAGNER. The reason they do not charge a load is because they are not selling to the public at all, but have their own clients.

Mr. SMITH. Yes; and if one sells to the public it is more.

Senator WAGNER. I do not mean that one should not charge a load, but I think the evidence you have presented here showed an average of 7 percent, and that some went as high as 20 percent.

Mr. SCHENKER. As high as 17.65 percent.

Senator WAGNER. Certainly that is high enough.

Senator TOWNSEND. Mr. Smith, this average you showed here gives about 6 percent, does it?

Mr. SMITH. That is right. Those are over-all figures and I think they included some that were higher and some that were lower.

Senator TOWNSEND. Yes, but the average is about 6 percent.

Mr. SMITH. Yes, sir.

Senator WAGNER (chairman of the subcommittee). You may go ahead, Mr. Smith.

Mr. SMITH. Just one other fact that will indicate the wide scope of the problems in this industry: Total repurchases of closed-end companies amounted to $533,737,000. These were made at aggregate discounts below asset values of well over $100,000,000. The losses to investors who sold their securities (on the basis of the difference between the repurchase prices and original offering prices) amounted to about $300,000,000. These losses on the basis of discounts below asset values were, of course, a gain to the remaining securityholders.

I think it is fair to say that in this huge volume of repurchases by investment companies of their own securities, there are relatively few cases in which there is not involved the fairness of the prices paid, either because one is buying a senior security at a big discount or because of its effect upon the common stock.

Senator TAFT. How do you account for the fact that closed-end company securities are sold below asset value? Is that a tax question primarily?

Mr. SMITH. I think it is partly a tax question, but I think a substantial part of it is caused by the tax discrimination against closed-end companies as opposed to open-end companies, in which the——

Senator TAFT (interposing). A part of this $300,000,000 loss is caused by the Government's tax policy, is it?

Mr. SMITH. Do you mean in the case of repurchases?

Senator TAFT. Yes.

Mr. SMITH. Well, I think this is so; that the Government's tax policy only went into effect in 1936, and these repurchases I think all took place prior to 1936. So that as far as that is concerned it would not affect these figures. As far as discounts today are concerned I think the Government's tax policy undoubtedly has an effect upon selling at a discount. A great many people have also testified that there is doubt whether the management can justify itself and the costs of operation.

Senator WAGNER. Is there discrimination as between closed-end and open-end investment trusts in the matter of imposition of the tax?

ADDITIONAL STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. SCHENKER. On that, Mr. Chairman, the present state of the law is that open-end companies have a tax exemption under 48 (e). Closed-end companies do not have the same tax treatment.

I might say that we have been in close contact with that proposition, and have discussed it with the representatives of the closed-end companies and others, and——

Senator TOWNSEND (interposing). Can you state why that is?

Mr. SCHENKER. Yes; I think I can state my difficulties with the tax exemption for open-end investment companies. Unfortunately there is no legislative history upon that provision in the tax law. As I remember it that was introduced on the floor and the first thing I knew about it was that the open-end companies as contra-distinguished from the closed-end companies, gained that tax exemption.

Senator WAGNER. What year was that?

Mr. SCHENKER. It was in 1936.

Senator TOWNSEND. Is it in the law or in a ruling?

Mr. SCHENKER. It is in the law. The tax exemption obtains if they distribute their income and capital gains—then they are not subject—I mean the corporation is not subject—to a tax on capital gains, but its shares are only subject to the single tax in the hands of shareholders. So that eliminates the double taxation.

There are two theories, or one major theory at least, advanced for that tax exemption. I think it was the President who said in some address that he could visualize if you had a simple company which was made available to small investors, a mutual company, then it might be entitled to some tax exemption.

Now, the so-called mutual company, or open-end company, was designated as the type of company which would be entitled to the tax exemption, although in my opinion the only difference between an open-end company and a closed-end company is the shareholder's right to redeem.

Now, to our minds—and we have expressed it before the Senate Finance Committee—there is no reason for discriminating between investment companies merely on the basis of redemption features. Securities of closed-end companies today are selling at a discount, which in my opinion to some extent reflects the tax situation. Mr. Bunker thinks we are responsible for it in a little measure with our investigation, but I think I am not being impertinent when I say I think it is due to the fact that the public have no confidence in the investment trust situation unless it is regulated.

After all the discount represents what? It represents the public's appraisal of management, the public's appraisal of what they think of the investment-trust institution. Because, what are they saying——

Senator TAFT (interposing). Do you not think it is fair to say it is due, more than any of the reasons you have given, to the public feeling that stocks are not going to go up, that they are more likely to go down? [Laughter.]

Mr. SCHENKER. It may very well be that that is so, Senator Taft.

Senator TAFT. And that they cannot get their money out, or if not that, what is it?

Mr. SCHENKER. What it means in simple terms is, that the public at the present time feels that a dollar in the hands of investment trust management is only worth 70 cents.

Their securities are selling at about a 25 to 30 percent discount. What that is attributable to I do not know; whether it is because of lack of confidence in management, in its expertness, or in the stock market, or because of the tax situation, I do not know.

Section 48 (e) has certain limitations. There is the limitation that you cannot have more than 5 percent in one company and cannot own more than 10 percent of the outstanding securities of one company. It has also the provision that your portfolio turnover cannot be more than a certain percentage. That is expressed in terms of gains on securities, held less than 6 months. It has also a provision about debt: If you have debt outstanding more than 10 percent of your assets the company is not entitled to the tax exemption.

The fact of the matter is that there are closed-end companies which can comply with all of these provisions, except that a stockholder should have the right of redemption. To our minds that is not a basis for discrimination between the companies, because as we will show a little later on, this open-end feature (as was stated by Mr. Leffler who started that type of company), is not an unmixed blessing.

With the open-end company you have a situation where you have to continue to sell your securities. You have all of the problems of distribution, sales load, and dilution. To our minds the test should be mutuality, as the name expresses, with supervision by some gov-entitled ernmental agency.

What is the situation today? Regardless of what the load is, and you can charge a 40-percent load, you would still be entitled to the tax exemption. Regardless of the management fees in the companies if you want to take a 100-percent profit—you still have the tax exemption. Regardless of what it costs to run the company you still have the tax exemption. Regardless of whether the stockholders have the right to vote or not, or to get rid of the management, you are to the tax exemption.

To us mutuality connotes mutuality. It is the same concept you would have in the case of a mutual savings bank. It is a mutual enterprise in that the management is subject to the votes of all the stockholders. We say the test should be not in redemption or no redemption, but whether it is a mutual company supervised by a governmental agency.

We feel, and the Commission has so told the industry, that if closed-end companies are supervised by a governmental agency, and you have that diversity feature, with one class of stock, and with the same right of vote in all stockholders, there is absolutely no reason for that discrimination. That is our approach to the tax problem.

May I say this: In giving this figure of an aggregate loss due to mismanagement of $1,100,000,000, I would like to indicate one or two things.

Mr. Bunker said he was talking about the "sample" and I was talking about "the specimen." Well, I say candidly, and I am not trying to impugn the whole industry—on the basis of this 4-year study—I was talking about the sample and he was talking about the specimen.

Mr. Bunker discussed his own company—and when you are talking about the Lehman Corporation you must remember that you are

talking about the creme de la creme of the investment trust industry. [Laughter.]

When you talk about performance in the investment trust industry—and he was discussing 49 hand-picked companies—companies which we picked as the largest companies which had only one management throughout their existence. We took the best companies, the best and largest companies, and we said: Let us see what management can do? We did not include all the companies that went broke. We did not include all the companies with mismanagement. We did not include them, because we said: Let us take the best companies and see what they can do with the management of other people's money.

Now, of this $1,100,000,000—and we will make the names of the companies available to the subcommittee if you wish—I think it might be unfortunate if the Securities and Exchange Commission were to say here there was mismanagement in this or that company, because you might get strike suits. But I will give their names to the subcommittee if you wish.

What did we do when we computed this $1,100,000,000 figure? United Founders had $500,000,000 and went down to $40,000,000. We did not include that $500,000,000 as due to mismanagement. We only picked out those situations where securities were unloaded on the company, where the management was acting with an ulterior motive. In regard to Founders we said approximately $300,000,000 of that shrinkage was due to mismanagement—if they mismanaged $300,000,000 it was probably the proximate cause for the loss to the rest of the funds, but this remainder was not included.

Now, in connection with the Eastern Utilities Investing Corporation, which went into the wringer, we did not include all the money that was put in. We tried to appraise these situations where there was mismanagement.

Take Mr. Smith's case of the loans to the bank officers. They loaned money to officers and directors, who got into margined accounts and gambled their heads off with investment-company funds and bank funds. We do not say all that money lost in those companies was due to mismanagement. We only took the loans to officers and directors. That is what I think Mr. Smith means.

Mr. SMITH. Yes.

Senator WAGNER. What company was that?

Mr. SCHENKER. The Liberty Share Corporation, up in Buffalo. I wanted to indicate the constituency of the figure 1,100,000,000.

Now, coming to this concept of performance: I say we were talking about the sample and he was talking about the specimen. I am prepared and would like to discuss—well, let us take the Lehman Corporation, which is as Mr. Bunker says, is the first or second best performing trust in this country.

I would like just to indicate this if I may, and I think I am right, and if not, Mr. Bunker will correct me. We have a wonderful instance in the case of the Lehman Corporation. I think they made their offering on September 25, 1929, and they got their money when the market commenced cracking, and were therefore in a fortunate position. When the real crack came they had cash; so that the statement made that they passed through the greatest cataclysm so far as October of 1929 is concerned, does not affect the Lehman Corporation. But I think that is a minor point.

Mr. Bunker, in his prepared statement on page 12, said:

Now this business of selecting specimens may be interesting but it is not very instructive. For example, if it fell to my lot to argue the other side of the case, I would produce specimens having as much virtue as the ones you have listened to had vice. To illustrate, it was necessary 3 years ago for my company to report on the state of its affairs before the Securities and Exchange Commission. I cite this particular example because the Securities and Exchange Commission is officially in possession of the same data.

I will read this carefully. I want to get it clearly before you:

It was able to state that for those stockholders who had paid $104 on the date of formation of the company, namely September 25, 1929, there were available for each share of stock on November 7, 1936, assets of a net value of $134.34; and that, further, in the meantime each share had received during that period of 7 years $19.35 in dividends.

Now, of course the thing that struck me immediately was this date, November 7, 1936, a date which looked like an odd date. But Mr. Bunker tells me that is the date he testified about.

I have here the report of the Lehman Corporation which sets forth a comparative table giving asset values of the Lehman Corporation for each year. Now, November 7, 1936, I am pretty sure was the peak of performance of the Lehman Corporation. If you take June 30, 1935—and we took in our questionnaire the cut-off date as of December 31, 1935—the Lehman Corporation had $31.33, and there was a 3 to 1 split-up. That means that they had $93 or $94 a share—and I am coming to the dividends in a moment. If you bring it down to date you would not have $134 for each share. What you have is $32.53, and if you multiply that by 3 you have $97 a share.

In the interim they paid an aggregate of $40 a share in dividends. That means they had $137 for the period.

Now, I am not going to make comparisons because as I will show in a moment nobody is more conscious than we are of the difficulties of management. The fact of the matter is that throughout this investigation we were insisting that managing other people's money was a tough job, and were insisting that unless you had the necessary precautions to stop looting and mismanagement, the industry as a whole would not serve a useful function.

You can make a comparison of this performance with Government bonds, in which event he would have $137 today. If he had it in a mutual savings bank he would have $137 today. And yet you must consider that this value of the Lehman stock today was only after—and Mr. Bunker will correct me on this if I am wrong—$1,800,000 was paid to Lehman Bros. for management fees, and Lehman Bros. got in addition about $1,500,000 to $2,000,000 in brokerage and about $3,500,000 to $5,000,000 was spent by Lehman Corporation for research in addition.

I am just pointing that out to show how difficult the task is of managing other people's money even when you try to do the job, and the danger there can be to the public if you let everybody else run around loose and unload securities and all that.

On thing further: I would like to analyze the $97 a share they have left today and see what the situation is. If you will bear with me one moment I would like for the Senators to take a look at page 10 of this report. This report will give you some indication of the conduct of this investigation. On the basis of the questionnaire material, we prepared a report on each company.

Senator TAFT. Is this the same thing that I now have before me?

Mr. SCHENKER. Yes, sir. We all have the same data. We prepared this report and then called them down here to Washington, and let them read it, discussed it with them, and let them criticize it.

On page 10 of the report what do we find?

Senator TOWNSEND. What is the procedure of a corporation purchasing its own stock?

Mr. SCHENKER. They just go out on the market and buy it. That is a very important problem, one that is entitled to a great deal of consideration, and I will discuss it in a moment.

They made the statement unequivocally—and I do not know why—that for every share of stock sold for $104 in 1929 they had $134 a share.

Now, if you will take a look at page 10 of that report you will see that the Lehman Corporation repurchased, within a period of little more than 2 years, 33½ percent of its total outstanding stock. In other words, within 2 years after the Lehman Corporation got started it brought back 33.7 percent of its own stock, and at what prices?

In 1929 it bought at an average price of $72.18, repurchasing 500 shares. In 1930 they repurchased 92,200 shares at $74.99. In 1931 they repurchased 140,200 shares at $46.29.

How about that fellow whose stock they bought back? He did not have $134. He got $46.29 for his $104. And that was the situation with respect to 140,200 shares.

In 1932 they bought back 98,000 shares at $34.31 a share. That fellow did not get $134 or $104, but only $34 for his $104.

And, similarly, in 1933 they were buying back their own shares at $41.65. The average price at which they repurchased all their shares was $50.79.

So that with respect to the holders of one-third of the total capital securities which Lehman Corporation issued, those fellows did not get $134 but $50.

One more angle: When they repurchased those shares they did not even pay the asset value to the fellow whose shares they were buying. Here was an individual who put money in the company. He says "You manage my funds." After 2 years for some reason best known to himself, whether he needed the money, or had lost confidence, or wanted to buy something else, he decided to get out of the Lehman Corporation.

The fact of the matter is, if you will take a look at the fifth column on that page you will see that those shares were bought back at a discount of over $6,000,000. That means that they paid those shareholders $6,000,000 less than market value at the time.

Senator TAFT. You mean asset value, do you not?

Mr. SCHENKER. Yes; I meant asset value. If the market value was $50 they really had $56 behind each share, and the company made a profit of $6,000,000.

What was the effect of these repurchases? The effect was that this discount amounted to $8.80 on every share outstanding today. So, the only thing they did was just to take from Peter Stockholder and pay to Paul Stockholder. So that when you consider the amount that is still left for the Lehman stockholders, you have to consider that $8.80 on each share was not due to management because they picked the right stocks and gave expert advice; they took the $8.80 from stockholder A who got out and gave it to stockholder B. And I am

talking about the best investment trust in this country. I am not being critical of them. I am just saying what we said in our report on performance, which Mr. Bunker said he read with great care, that difficulties in management of large investment accounts have long been recognized in connection with insurance companies, trust companies, investment counsel organizations, educational and charitable foundations or similar institutions, and detailed scientific studies have been made, and the appearance relatively recently of a considerable number of investment trusts have given us the opportunity of making a study. And then we say that, however, the full significance in the implications to the investor in the performance of investment trust companies cannot be completely evaluated until studies of these other investment institutions shall have become available.

You can make any comparison you desire; you can take the individual who invested in the Lehman Corporation, the best investment trust in the country, and can compare his experience with the fellow who bought Government bonds, kept his money in the bank or bought phony oil stock. I am not unmindful that there were people who bought such oil stock.

That is the reason why Commissioner Mathews, who is not prone to exaggeration and was one of our real outstanding commissioners, after a great deal of thought said (reading):

> Speaking in general terms, the investment trust has not supplied capital to industry. The exceptions have been trivial and unimportant in their relation to our economy. Regulation cannot be charged with having the effect of stifling industry. Again speaking with individual and negligible exceptions excluded, the only real function which makes the existence of these institutions important to the country is that they supply a means by which a great number of investors may own a share in industry with such advantages as flow from diversification of investment and employment of expert management.

This is the sentence that I think is very important (reading further):

> At their best, investment trusts serve these purposes. At something less than their best, the reputed advantages of diversification and of expert management are more than offset by the dangers which the mass of investors encounters in them.

Our only function is to see if we cannot be helpful in eliminating these dangers, because the problem of the investment company's management is difficult enough as it is.

Senator Townsend. Have you placed in the record a list of the type of people who invest in these securities?

Mr. Schenker. On that aspect, Senator, we have done this. We have made a very detailed study of the average holding of the closed-end companies, and found that the largest number of stockholders hold shares worth about $500. I think in connection with the open-end companies the figure is about the same. When you come to the installment plan—and you have heard the elaboration upon that—then you get down to the class where they sell them at $10 a month and $10 when you can catch them. They sell to miners, servant girls, policemen, and get down to the lowest income brackets. In fact, they get down so low that they have told us that in many instances if the initial payment were $15 instead of $10 they could not make the sale, because the person did not have the extra $5. They get down to $2.50 a week. A fellow figures that he will give up a couple of glasses of beer and invest in these plans with their common stocks. As soon as the price gets up to $4 a week they cannot meet that obligation.

The most important vehicle for distribution of investment trust securities is selling on the installment plan. I asked one of them, "Would you think of selling these individuals a share of United States Steel?" He said, "No." Yet they take a package consisting of steel and other stocks and give the package a fancy name like thrift plan or saving plan and sell an interest in this package to these individuals in the lowest income brackets.

Senator TAFT. I have got to go to the floor of the Senate, and I would like to ask you a question. On those figures of Lehman Bros.' repurchases will you attach to that the average asset value? You have given the discount from the original purchase price, but you have not given the discount from the asset value.

Mr. SCHENKER. That would be about $6,000,000, the discount from asset value.

Senator TAFT. Is that stated in the list?

Mr. SCHENKER. Yes. They were buying it at $70 below the offering price and buying it at 25-percent discount from asset value, and that amounted to six-million-and-some-odd thousand dollars. It was $8.80 a share.

Senator TAFT. Before they purchased, there was a market price. The stock was sold on the New York Stock Exchange?

Mr. SCHENKER. Yes.

Senator TAFT. So their purchasing probably raised the price rather than lowered it?

Mr. SCHENKER. Shall I say, "stabilized" it?

Senator TAFT. All right. But the tendency would be to raise the price rather than to depress it?

Mr. SCHENKER. Yes. Just give me one second. The repurchases in 1930 were approximately 11 percent of the total volume of the reported sales in Lehman Corporation stock on the New York Stock Exchange and the New York Curb Exchange, and the repurchases in 1931 were about 30 percent of the reported volume on the New York Stock Exchange.

During 1930 Lehman Corporation bought back its own stock at $50 when its offering price had been $134. What is the effect of that, Senator? I am not denying that they may have been distress sellers and were anxious to get out, and they may have been helped by these repurchases. But, on the other hand, people may have believed the Lehman Corporation is a fine corporation because of the good market behavior of its stock. Therefore you really do not get an accurate picture of the public's appraisal of Lehman Bros.' management, because the market price prevailing at the time does not represent the public's purchasing and the public's appraisal of Lehman Bros.; it represents the purchasing by the Lehman Corporation.

Senator TAFT. Except that at the time of these large purchases there just was no market for anything. The bottom had just dropped out of the market—the same way the Government holds up farm prices. I think we had rather an extraordinary condition at the time of the big purchases.

Mr. SCHENKER. But this was not in 1929. It was in 1931 they bought 140,000 shares.

Senator TAFT. That is what I say. The bottom dropped out in 1931, too.

Mr. SCHENKER. In 1932 they purchased 98,000 shares at $34.

Senator TAFT. I was thinking that it would be hard to say, at that time, with demoralized prices, whether people thought highly of Lehman Bros. or not.

Mr. SCHENKER. That is why I say they may have been performing a useful function in supplying a market to distressed sellers, who probably got a better price. But I just want to show the significance, and we think it is one of the important problems, when you deal with repurchases of their own stock. That is why we deal with that problem in the bill, Senator—when you take the one-class stock trusts repurchases present such difficult problems, you can imagine what it does when you have senior securities in the capital structure. If Lehman Bros. had senior securities, Senator, every time they bought back stock, the question would have been presented as to the fairness to the preferred-stock holder, to the debenture holder, or to the common-stock holder?

Senator TAFT. I think the whole policy is a doubtful one. I do not question that.

Mr. SCHENKER. You have the same problem when you take the open-end company with senior securities.

Senator TAFT. It is more doubtful where you have various securities than where you have just one.

Senator WAGNER. Is your testimony in criticism of the practice of buying securities, or is it that you wanted to account for the difference in the——

Mr. SCHENKER. I just wanted to do this, if posterity should happen to read the transcript of this testimony—I did not want to appear to have overlooked the effect of the repurchases on the performance of Lehman Corporation.

I wanted to give some of the facts in connection with this $134, and just to show how difficult a job it is to manage other people's money. That is why we say that unless you regulate this industry as a whole it might not serve a useful function. If all trust companies were like Lehman Corporation we would not be here. There is no question about that.

I sat here for a couple of weeks, Senators, and I heard in connection with those prepared statements, "I am not a lawyer"; and then the reader would lift a legal left hook from the floor—a hook evidently coached by some lawyer.

Now, I am not a statistician, Senators, but at the same time we undertook to study the performance of investment trusts. We wanted to be fair about it, and we picked the 49 largest companies in the country to see how they managed other people's money. We took those companies and we tried to devise a concept to see how well they were able to handle this fund. Our statisticians will describe the technique we used. Then, in order to get some basis of comparison, we said, "Let us see if they can do better than the Standard Statistics 90-stock average or worse." There has been some criticism of the use of the 90-stock average. Our statisticians will explain that. But I just want to make this observation, that before we completed our study various periodicals tried to appraise the value of the management on the basis of the performance of investment companies. When our study appeared I got this letter from Barron's National Financial Weekly, and I would like to read one paragraph from that

letter. They acknowledged receipt of the report, and the writer says [reading]:

My main interest in it is due to the fact that I have been working for some time trying to set up a performance gage for the closed-end trusts, similar to the one sheet we are already publishing at the end of each quarter, for about 20 open-end companies. Publication of your report has, I hope, solved the difficulty in choosing the best formula to follow. I shall simply use yours—

And so forth.

After our report on performance of investment companies came out Barron's said they adopted the Commission's method of measuring performance.

Here [indicating] is Barron's published by the Wall Street Journal. When they tried to appraise the performance of investment companies they did not use Standard Statistics 90-stock index; they used the Dow Jones index. The Wall Street Journal publishes Dow Jones; so they used their own index. So, if you have difficulty with the 90-stock index as a yardstick, you must have difficulty with Dow Jones yardstick.

Barron's use our method of comparison to appraise management. Mr. Winston, who supplies the entire industry with data or material on performance, uses the 90-stock index. The fact of the matter is that in their sales literature, when they sell investment companies' securities, many companies stated, "You see we have been able to do better than the 90-stock average."

Just one other observation—and I know Mr. Bunker will not become angry with me. There was a comparison made by Mr. Bunker between a list of securities which was published by a leading statistical organization, and he showed what would have happened if you had invested in that list and what would happen if you invested in the 49 handpicked investment companies. One of our statisticians will attempt to show the fallacies of Mr. Bunker's reasoning; but I just want to make this observation. In some respects I do not think he was very complimentary to our investigatory ability. There were only one or two companies in the world which could have issued that list and we located that statistical agency. That list was contained in a weekly letter and that is changed practically every week. I do not think that Mr. Bunker even remotely contends that the investment adviser service said, "You buy these stocks and put them away and forget them for 10 years." That was not the nature of their recommendation at all. And as I understand it—I would not be sure—the statistical organization had not a little difficulty with the use of the list for the comparison made by Mr. Bunker. I may be wrong about that. However, as I say, I am not a statistician, and therefore I have to rely on the New York Times sometimes. Evidently Mr. Bunker's comparison had a hole in it so big that it was visible 250 miles away, because within 24 hours the financial editor of the New York Times wrote [reading]:

STATISTICS

Somebody connected with the closed-end investment trusts went to a great deal of trouble in gathering statistics to show that the average trust performed a great deal better between 1929 and 1935 than did the average new security issue floated in 1929. The first group, it appears, lost 51 percent of its initial value in that period; the latter, only 44 percent. It should be obvious that a company which raises money and buys material and equipment at the peak of a price movement has less chance of succeeding than one which buys at any other time. In

fact, it is hard to think of any considerable group of securities which might have fared worse than the issues of 1929. If the investment trusts can think of no better proof of the average advantages of their management, perhaps they had better stick to the trusts which have managed to do better than the standard average.

I just want to indicate that Mr. Bunker found difficulty with our analysis, and evidently other people find difficulty with his analysis.

(The article on investment company performance referred to and submitted by the witness is as follows:)

[From Barrons, February 6, 1939]

INVESTMENT COMPANY PERFORMANCE ANALYZED BY SECURITIES AND EXCHANGE COMMISSION—RESULTS FOR 1927–1937 PERIOD FOUND SIMILAR TO COURSE OF GENERAL MARKET

For the entire period 1927–37 investment-company management as a whole obtained results which were neither significantly better nor significantly worse than the results which could have been obtained from an "unmanaged" fund placed in a common-stock index. This is the conclusion reached by the Securities and Exchange Commission after an exhaustive study of the management performance of 85 large companies of both closed-end and open-end type.

In sending to Congress last week this chapter of its report on the study of investment trusts and investment companies, the Securities and Exchange Commission emphasized that the full significance and implications of the analysis cannot be completely evaluated until studies of such other investment institutions as insurance companies, trust companies, investment counsel organizations, educational and charitable foundations become avaiable. The Securities and Exchange Commission also pointed out that they were not setting up a stock index as a standard of performance and suggested that what the investors in these companies would have done had they not bought investment company securities should be considered.

The present analysis does not discuss the actual experience of investors who bought investment company securities. The concept of performance employed is described as the "extent to which * * * the fund or assets which management controls is enhanced or diminished over a particular period as a result of the investment policies, activities or decisions of the management." A future report will deal with the actual experience of investors in investment companies.

The average large closed end investment company—"closed end" companies are those with relatively fixed capital structures— was found to have performed a little worse than the general trend of common stock prices in each of the years 1927, 1928, 1933 and 1935, and a little better in 1929, 1930, 1931, 1932 and 1934. In other words, investment companies as a group have generally failed to do as well as the market in years of rising prices and have succeeded in doing a little better in years of declining prices.

This tendency the Securities and Exchange Commission attributes primarily to the fact that the companies characteristically keep a small though varying proportion of their assets in cash and other liquid items which are not substantially affected by stock price movements, and in preferred stocks and bonds which fluctuate less violently than common stocks.

VARIATION IN INDIVIDUAL RESULTS

The Securities and Exchange Commission found, of course, considerable variation when it came to study the management performance of the individual companies. No single company was able to do better than the general market in all of the 6 years from 1930 to 1935, but three companies were found which achieved this in 5 of the 6 years. Little evidence of consistency in yearly performance ranking among the various companies as compared with each other was found, although some companies displayed a tendency to perform consistently during years of rising security prices and to perform consistently during years of declining security prices.

Taking the period 1930–35 as a whole, and assuming the reinvestment of all distributions to security holders, the Securities and Exchange Commission found that the typical large closed-end management investment company would have been about 12 percent better off if it had retained its funds in cash, rather than investing them. This comparison, the Securities and Exchange Commission

warned, is applicable only to the particular period and does not give any indication of the comparative experience in other periods.

During the same period, the performance of individual companies ranged from an increase, including distributions, of 60 percent to a shrinkage, also including distributions, of 80 percent. Among 38 companies for which 1936 and 1937 figures were obtained, the range for the period 1930–37 was from an increase of 35 percent to a decrease of 85 percent. The average for the group was a 23.3 percent decrease, compared with a 24.2 percent decrease in a common-stock index.

Substantially the same results were shown for the 36 open-end companies studied. The open-end companies, sometimes called mutual funds, are those which buy back their shares at liquidating value. Most such companies continuously sell new shares directly to the public at the underlying asset value plus a commission. Average performance of this group for the entire period 1929–37 was just about the same as for the closed-end group and virtually identical with the common-stock index.

Individual companies in the open-end group showed less variation in overall results than did the closed-end group, the range for the period 1930–37 being from an increase of 29 percent to a decrease of 39 percent. The average decrease of 17.8 percent compared with an average decrease in the common-stock index of 24.2 percent. This 8-year comparison is based on the performance of only 11 companies.

OTHER HIGHLIGHTS IN SECURITIES EXCHANGE COMMISSION REPORT

Other observations and conclusions of the Securities Exchange Commission, based on the analysis of investment company performance, included:

1. Performance over the period suggests the historical superiority, among closed-end companies, of the diversified nonleverage companies formed in 1928–29.
2. A definite relationship between the incurring of bank debt by investment companies and poor performance over the period 1930–35 as indicated. Investment companies with large bank debt had an average shrinkage in their funds of 69 percent, as compared with a 39 percent shrinkage in funds of companies with moderate bank debt, and an approximately 8 percent shrinkage in funds of companies with no sizable bank debt.
3. The typical performance of fixed trusts was inferior to that of the management investment companies analyzed, although not significantly so.
4. Companies of the closed type which traded extensively in their portfolio securities did not perform much differently from companies which traded moderately or inconsiderably. Among the open-end companies, the Securities Exchange Commission reported some indication that extensive trading in portfolio securities was associated with relatively poor performance for the years 1933–35.
5. For the period 1930–35, as a whole, the companies with diversified portfolios did not experience the extreme variations in performance that companies specializing in utility stocks and other specialized companies did.

STATEMENT OF RAYMOND W. GOLDSMITH, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Goldsmith. My name is Raymond W. Goldsmith. I am one of the assistant directors of the Trading and Exchange Division of the Commission and in charge of its Research and Statistics Section, and I would like to explain, if the committee will bear with me for about half an hour, how we calculated what we call (and what has been referred to here several times as) investors' experience.

It is true that we have set forth in as much detail as we thought fit in chapter VII of part 2 of the Commission's report, what we meant by that term and how we calculated it. However, notwithstanding our best efforts, I take it from the testimony of some representatives of investment companies that that concept and the method of calculation have been misunderstood by at least part of the industry. The criticism which you have heard, though it was sporadic, may have left some members of the committee with the impression that something

is wrong with our calculations. We therefore appreciate this opportunity of letting the members of the committee see for themselves how valid our results are and how much or how little merit there is to the strictures against them which have been made. We are also glad to have an opportunity of extending to the end of 1939 some of the calculations of the report which covered the period through 1935.

We measure investors' experience by subtracting from the amount of money originally paid by investors for the investment companies' securities the sum of two items, namely, (*a*) the amount of money repaid to investors by investment companies in connection with the repurchase of their own outstanding securities, and (*b*) the amount of funds preserved for investors in the form of the net assets of the investment companies at the date with which the calculation ends; either the end of 1935 or the end of 1939, or at the date of liquidation of the company, if that was different from either of these closing dates.

If the amount of money paid by investors for the securities of investment companies and trusts over the period is larger than the sum of the amount repaid to them during the period and the amount preserved for them at the end of the period, we may speak of a capital loss to investors.

If, on the other hand, the amount originally paid is less than the sum of the amounts repaid and preserved, investors may be said to have made a capital gain as a result of their purchases of the securities of investment companies and trusts. Both investors' gain or loss, as here calculated, are, of course, partly unrealized at the closing date of the calculation. Definitive determination of the realized loss or gain would have to wait for liquidation of all companies covered.

Investors' experience seems to us to be a fairly simple concept. It is essentially a statement (in accounting form) of certain items of outgo and receipts of those investors who participated in the companies which we have under investigation. There is not much that is hypothetical about the whole calculation except, of course, that a value must be put on such assets as investment companies and trusts still hold at the end of the period which is studied; that is, December 31, 1935, for the calculations in the Commission's report, or December 31, 1939, for some of the figures which I am going to cite. We have accepted the market values, as shown in the companies' reports, as a measure of the realizable value of assets. It is only because we do not have exact data for all of the 1,300 investment companies and trusts which have existed at some time during the last 10 years, that we were forced to resort to a number of estimates in making these calculations. The margin of error in these estimates, however, is small enough to make us feel confident that the true figures cannot be significantly different from those which we have presented in the Commission's report and which I am citing here. That complete accuracy cannot be obtained in calculations of this type—meaning accuracy to the last dollar or cent—every expert knows.

The actual amount of investors' capital gain or loss given by our measure of investors' experience has no ulterior implications. What the experience of investors would have been had they not invested in the securities of investment companies, or had they bought and redeemed those securities at different times, are matters of conjecture, of course matters of importance for several aspects of the bill under consideration. But our measure of investors' experience per se

is not concerned with such hypothetical situations. It is simply a figure in dollars and cents, or, rather, I should say, in millions of dollars, representing the loss incurred by investors in investment companies under the assumption that the companies were liquidated at the end of the period covered by the calculation, and that the value of the securities still outstanding at the end of the period is represented by the market value of the underlying assets.

It is important to realize, particularly in view of the apparent failure of several of the representatives of the industry to do so, that investors' experience is not the same thing as performance. There are certain differences in calculation and there are differences in the point of view from which you apply the two concepts.

Investors' experience views the problem strictly from the investors' angle and reflects the net effect of a multitude of forces at work over the entire period covered by the analysis. The calculation does not try to ascribe investors' capital loss or gain to specific causes. In particular, it does not tell to what extent a company's management was responsible for the capital gains or losses of the investors participating in that company.

If there is interest in further discussion of the difference, I think it can be conducted by Mr. Vass, who has made a study of performance.

Now, I want to clear up briefly at this point two points as to which, by their testimony before this committee, some representatives of the industry have misunderstood our procedure. Those are two very simple points which can easily be dealt with. I will clear up a few other points, a little bit more complicated, as I come to the relevant sections of the calculation.

Mr. Bunker, in a section of his testimony labeled "Erroneous impression of losses," imagined—he was not quite sure that he was right—that we failed in our calculations to give credit to the investment companies for the money returned to security holders in connection with repurchases. Of course his assumption is erroneous—a look at chapter VII would have settled that matter right away—and you will see, when you consider the actual figures, that the much discussed capital loss or shrinkage of $3,000,000,000 is arrived at after crediting the investment companies with nearly $1,600,000,000 for repurchases of their own securities. So, notwithstanding Mr. Bunker's impression—the loss or shrinkage is $3,000,000,000.

Mr. Griswold, in presenting calculations purporting to be made in accordance with our method, started with the net proceeds to the companies of their issues of securities instead of beginning, as is done in our calculations, with the amount paid for these securities by investors. Thus to disregard the cost of selling investment-company securities seems erroneous if we want to measure investors' experience. What the investor is interested in is what happened to all the money which he paid for the securities of investment companies, and he does not care, whether he paid 90 cents on the dollar for the underlying assets and 10 cents for the service which was supposedly done him in selling the securities. So I cannot see how that argument has any validity against the calculation of investors' experience or investors' capital losses by our method. This item of load, as you have heard, is by no means of negligible proportions. It amounts to about $500,000,000.

We have interspersed in our report a lot of limitations, hedges, and so forth, and I am only going to refer to one or two, because they are sometimes overlooked.

It is important to keep in mind that the figures for the capital gain or loss to investors in any company reflect the experience of all investors participating in that company at any time during the period covered, not solely the experience of investors holding securities at the end of 1935 or 1939, as the case may be.

Moreover, the figures which we have shown in the report show in one aggregate the experience of bondholders, preferred stockholders and common stockholders. They do not differentiate, because we did not have in all cases sufficient data, between the experience of the general investing public or of the insiders. Therefore this total loss which we show is not the loss of the general investing public and it does not take into account that in issuing the securities there was in a number of cases a certain amount that passed from the pockets of the general public directly into the pockets of the insiders. I have told you that we start with the offering price of the securities. In many cases, particularly before 1930, the company originally issued the securities to a group of insiders, say, at $10. They then turned around and with the help of a little market manipulation put the price up to $20, and that was the price at which the public bought. There are numerous cases of that.

Senator Wagner. Do the insiders as a rule sell their stock?

Mr. Goldsmith. We have a number of cases where they did that. In other cases they have held on to all or part of their holdings. In some cases where the insiders organized the company with the intent of running it and controlling it and having a stake in it, they stuck with it. In other cases this set-up was chosen to give the insiders an intermediary profit. There are a number of cases of that type discussed in detail in the Commission's report, in part III. But the point I want to make is that we take the securities at their original offering price.

Finally, we have shown separate figures for investment company gain or loss only for certain broad groups of investment companies; and I want to repeat that there are many investment companies for which investors' experience is much better, and others for which it is much worse, than the aggregate figures which we have calculated.

I now come to a problem which apparently has given at least some representatives of the industry some trouble, and that is the losses on repurchases. This is simpler than the discussion on repurchases at below asset value and market value, which you have just heard.

We feel that since what we have measured is simply what happened to the money contributed by investors, it is perfectly proper to include among capital losses the loss suffered by those investors who redeemed their shares at the low prices of the depression, or whenever it may have been. Such losses are not offset, if the price later rises, by the gain of any other participating investor, as is the case when one investor sells a security to another investor on the stock exchange.

Mr. Griswold thought he had us beaten when he cited the example of 1,000,000 shares of U. S. Steel originally offered—I suppose he meant originally offered in 1929—at $250 and then sold on the stock exchange in 1932 at $25 by one investor to another.

That is 100 percent beside the point, because while the shares remain outstanding and just one investor sells to the other, if the price afterwards goes up to $100, the first investor may regret his folly and the other has the advantage, but for all investors of the United States Steel Co. it washes out. This by no means is the case when an investor redeems, because there is no other investor who profits when the price later rises. It is not necessary to calculate losses in redemptions in any different way in open-end or closed-end companies, as Mr. Griswold intimated. If there is a net redemption—and I will come to that in a moment—it has the same effect whether it is an open-end company or a closed-end company. The share is canceled, and the loss of the redeeming investor is final.

I hope I have shown that there is no theoretical basis to Mr. Griswold's objection. Now I am going one step further and discuss the practical importance, and I will make that very brief. Obviously it is practically important only if there is net redemption, because if the same amount of shares is redeemed and then sold—and that is, of course, what the general practice would be in an open-end company—it washes out.

Mr. Griswold, by his emphasis on redemptions at low prices, may have given the committee the impression, though unintentionally, I am sure, that there were heavy net redemptions in open-end companies during those terrible years when the bottom dropped out of everything. But that is unfortunately, or fortunately, not the case. In table 81 of chapter III of part II of the Commission's report we have shown this for 40 open-end companies, practically all companies that were then actively selling. These companies took in more money from the sale of their own shares than they paid out in redemptions in every year between 1927 and 1936. In both 1930 and 1931, for instance, proceeds from new sales were about twice as large as cost of repurchases; and in 1932 sales exceeded repurchases by over 200 percent.

Even on a quarterly basis there were only two instances, namely, the fourth quarter of 1930 and the third quarter of 1931, in which net redemptions took place and in both cases net redemptions were very small, namely, under half a million dollars per quarter.

Mr. Griswold, using an expression coined in a different connection, has called this simple and, I think, self-evident calculation "a statistical monstrosity." I leave it to the committee's judgment whether such strong words are in order. I beg to submit that calling this a "statistical monstrosity" is due either to an inherent horror of simple arithmetic, or to a failure to understand the difference between investors' experience and performance.

I want to say now a word about the coverage of our calculations, just to show the committee how we did it. We made detailed calculations——

Senator WAGNER. Before you get to that: Did you ever go into the question of dilution at all?

Mr. GOLDSMITH. No, sir.

Senator WAGNER. You discussed the question of redemption.

Mr. GOLDSMITH. We credited the companies with the money they paid out and we debited them with the money which investors paid. So that would not come in there. One fellow's gain is the other fellow's loss, and that washes out. We took the experience of all the

investors together. We cannot segregate a certain group of investors and say what they made or lost. That is why I emphasize that we cannot segregate the insiders, for instance.

Senator WAGNER. The stockholder, before the dilution took place, was just deprived of a certain amount. I was wondering whether you had gone into that.

Mr. GOLDSMITH. No, sir. The companies covered by these calculations include practically every trust or company having assets at any time in excess of $10,000,000, and there were about 200 of them, and they accounted together for 75 percent, approximately, of the total funds invested in all investment trusts and companies.

These figures were taken from the balance sheets furnished us by the investment companies and trusts, or derived from their books and documents by the Commission's accountants, or, in a few cases, from financial manuals. Then they were supplemented by estimates for the remaining numerous but smaller investment companies and trusts for which similar detailed calculations could not be made. Those estimates, which of course can be in error to a certain extent, cover only about 25 percent.

What we have here therefore to speak again in mining engineer's language, is neither a specimen nor a sample, but it is a whole body of ore in the mine.

These calculations were made in an earlier phase of the Commission's study, and they covered the period from the beginning of 1927 when investment companies and trusts first began to be of importance, through the end of 1935. We have recently made some attempts to extend them to 1939. They are considerably less reliable, necessarily, than the figures for the earlier period.

If the committee will still bear with me, I will use a wall chart to make clear what we added and subtracted, and then to show what some of the arithmetical results are.

These are essentially charts which have appeared in the Commission's reports. There is nothing new about this chart, but I would like to show what we did and whether we accomplished a "monstrosity" or not.

This chart has six double bars, and it covers all investment companies or trusts with the exception of two small groups. We have omitted installment investment plans and common trust funds, because the aggregates involved are too small to show distinctly on the chart.

The left-hand side of each bar is made up of two items. At the bottom we have, in orange, the net assets of the companies at January 1, 1927; and that means total assets minus all liabilities which are not evidenced by securities, such as bank debts, unpaid dividends, and current accounts payable.

The second section of the left-hand side of the bar, the one in brown [indicating on chart]; shows the amount of money which investors paid from January 1, 1927, through December 31, 1935, for the securities issued by the investment companies and trusts.

For all companies and trusts included in our calculations the net assets at the beginning of 1927 are slightly below $900,000,000. The gross proceeds from securities sold from 1927 through 1935 are slightly above $7,000,000,000.

This brown section [indicating on chart] includes nearly $500,000,000 of merchandising expense.

If we had included the years 1936 through 1939, the left-hand side of this bar [indicating] would only be slightly higher, as sales of investment-company securities during those 4 years are estimated at not much over $400,000,000.

The left half of the bar shows the total amount of money taken in from investors by investment companies and trusts to the end of 1935. The right-hand side shows what became of the money taken in. At the bottom you see, in green, the market value of the assets at December 31, 1935, and that is slightly less than 3½ billion dollars. We have estimated that the comparable figure for the end of 1939 would be about 3¼ billion dollars, a quarter of a billion less.

Senator WAGNER. You mean, the assets of gains?

Mr. GOLDSMITH. No; the assets are smaller. That is due to various factors—management, decline in security prices, redemptions, and so on.

Then we have in blue the sums which investment trusts and companies paid out in the process of repurchasing their own securities.

Senator WAGNER. How much is that?

Mr. GOLDSMITH. That is about $1,500,000,000 up to the end of 1935, and probably up to $1,800,000,000 if we carried it through 1939.

If investment companies and trusts had managed to preserve intact the funds they had at the beginning of 1927 and those received from investors during the period from 1927 through 1935, or 1939, and if they had paid out their net current earnings as interest and dividends, then the two bars of course would be equal.

But you see from the chart that that is not the case, and that there remains a distance to go on the right-hand side before we come to the end of the left half of the bar. The difference of approximately $3,000,000,000, shown appropriately in red, represents the amount by which the assets retained for or returned to investors fall short of the money received from them. That is what we have called investors' capital loss or shrinkage. You can call it whatever you want to. It is the difference between the money paid in and returned by repurchases or retained. We give the companies, of course, credit not only for the assets which they still have in 1935, but for those which they returned to investors through repurchase of their own securities.

Senator WAGNER. Do you have the prices of the repurchases?

Mr. GOLDSMITH. The repurchases are taken at the price which was paid by the investment companies to the investors who redeemed the shares. Therefore the losses on redemptions form part of this. We did not have enough material to calculate it separately. Mr. Schenker cited one example, and we figured it for a number of companies, but we did not feel we could make any over-all estimate.

Senator WAGNER. According to your chart the investors lost about $3,000,000,000?

Mr. GOLDSMITH. Yes, sir. I have tried to make clear how this figure is calculated and just what the 3 billion is.

There is a dotted line here [indicating on chart] because there is a similar break in the charts when published in the report. The total red section represents capital losses. You can try to split it up in two parts to see what happens. How did that money go out? This part here [indicating] would be equivalent to the dividends and interest paid out.

I will show briefly why that is included in capital loss and is not deducted from capital loss. I think that is not so difficult. To take the payments of dividends and interest into account in the calculation of investors' capital loss would be to commingle and confuse capital, which is not good accounting. It would imply that the security holder was not entitled to receive any return on his money, and if he only preserved what he ever had that was all he could expect.

The interest and dividend payments, according to our estimates, have averaged not much more than 2 percent on the amount paid by the public for the securities issued by investment companies, namely, approximately $7,000,000,000.

Senator WAGNER. Did those dividends represent payments out of capital?

Mr. GOLDSMITH. There has been a long discussion about that.

Senator WAGNER. I did not want to get you into a long discussion.

Mr. GOLDSMITH. I am not an accountant nor a lawyer, and I do not want to get into a discussion of that.

Senator WAGNER. You did not calculate that, then?

Mr. GOLDSMITH. No. We only took from the records what was the total of dividends and interest paid out; whether it was earned or unearned we do not know. That is an extremely difficult problem in each individual case.

Senator WAGNER. You attribute it to capital loss to the investors?

Mr. GOLDSMITH. That is correct.

Senator WAGNER. If a dividend is paid out there is not any capital loss to the investor, is there?

Mr. GOLDSMITH. There would be two possibilities of treating dividend and interest payments. We could take into consideration not only the money paid out but also allow the investor the normal interest. You can make it 3 percent or 4 percent or whatever it is. We lean over backward in not debiting them with what the money should have earned and in crediting them with what they actually paid out in dividends. They paid out on an average only somewhat over 2 percent a year, and that is, whichever way you look at it, less than the going rate for the hire of money. Government bonds yielded about 3 percent for the period as a whole. Even time deposits probably have brought somewhat over 2 percent.

Senator HERRING. Is it not a fact that the only one who would be penalized by that is the one who has paid out of capital rather than out of earnings?

Mr. GOLDSMITH. It is true that there are companies that have paid out more than 2 percent. But if we take the industry as a whole, there are others who paid less than 2 percent. I do not want to say that there are not companies who did not pay considerably more than that.

Senator WAGNER. I want to ask you another question. This [indicating on chart] represents capital loss, and you told us a moment ago that from this black line down that loss represents dividends paid out.

Mr. GOLDSMITH. That is to indicate that they paid out dividends to that extent. I just wanted to explain why we are rather leaning over backward, rather than the reverse, because if I had tried to make a statement on both capital and income experience, then I would have had to debit them, obviously, with the hire of money at rate, for

instance the rate Government bonds draw, and that would have been much more than this, so that the loss would be larger than I have shown it here.

Senator WAGNER. Whenever dividend payment results in capital loss, it must mean that the dividends came out of capital, does it not? Otherwise it would not be a loss of capital.

Mr. GOLDSMITH. During the time of capital impairment all their payments were out of capital. If these were all one company, then you could say that. But this is a total for numerous companies, some of whom paid out of capital and others did not. Thus I do not make any such claim. If all of them were (statistically) lumped together, all the dividends could be said to have been paid out of capital——

Senator WAGNER. Not all the dividends. You mean the dividends which resulted in a loss of capital?

Mr. GOLDSMITH. Yes; because in 1927 and 1928 there were earnings and capital gains. After 1929, for the industry as a whole, there was a capital impairment.

Senator WAGNER. What about earnings?

Senator HERRING. If they are paid out of earnings they are not penalized.

Mr. GOLDSMITH. This [indicating on chart] is the total dividend and interest they paid.

Senator WAGNER. You mean, out of earnings too?

Mr. GOLDSMITH. All dividends which they paid. Of those dividends which they paid you cannot know which ones came out of earned income or capital gains or capital surplus. All these payments made up somewhat over 2 percent a year on original investment.

Senator WAGNER. I do not want to pursue this question too far, because it may be that I am on the wrong track; but if that represents all the dividends, then there were no dividends that were actually earned on capital?

Mr. GOLDSMITH. It would have been simpler if I had not put this in, but since we discussed it in the report I did not want to lay ourselves open to having it said, "The guy went back on his own statement and didn't explain it fully." I have given considerable consideration to not burdening the record with this discussion but I did not want to give the impression that I was suppressing anything which we had in the report.

Senator WAGNER. If dividends are paid as a result of earnings by capital, then those dividends do not reduce the capital, do they?

Mr. GOLDSMITH. No.

Senator WAGNER. So when you speak of dividends that result in capital loss, they cannot be earned dividends?

Mr. GOLDSMITH. The dividends do not result in loss, of course——

Senator WAGNER. Unless they are paid out of capital?

Mr. GOLDSMITH. Even if they are paid out of capital they are not lost. But in a certain sense they are a return of capital.

I am sorry that I took so much time on this.

Senator WAGNER. I am responsible for that.

Mr. GOLDSMITH. I do not need to explain much about the other bars. They are just for the five main groups of investment companies. But we have also made some calculations and have charts for a number of important subgroups within the two largest groups, namely, the

management investment companies proper and the management investment holding companies. Those are exactly the charts which we have printed.

There is one thing, however, that I think I should say, and that is that there is one group in which investors did not make a capital loss, but made a capital gain. It would have been shown in white on the wall chart if there had been any opportunity for it.

This was a group made up of three large investing holding companies, investing in chemical securities. It is, however, a fact that the American investing public has had but a very small participation in the profit of these three successful companies, because the overwhelming bulk of their equity securities is owned by a few large shareholders, domestic shareholders in one of the three companies and foreign shareholders in two of the companies. Therefore, if we wanted to get a little bit nearer to the experience of the general investing public, we have to eliminate these three companies, in which case the investors' loss would go up about a quarter of a billion. It would be 3¼ billion rather than 3 billion dollars.

I also have another chart that shows the situation at the end of 1939. The changes are small. It is generally, of course, the same picture, since there were only small sales and small repurchases. The investors' loss, as we calculate it, as of the end of 1939, would be slightly larger, say, 3¼ billions instead of 3 billions to the end of 1935.

Senator WAGNER. This chart makes it very clear to me.

Mr. GOLDSMITH. I had some further remarks with reference to a comparison of investors' experience with the experience in other forms of investment, but I can skip that. That has been covered partly by Mr. Schenker; and Mr. Vass, when he discusses performance, will tell you more about it. So, unless you specifically desire to hear about that, I will skip it.

Senator WAGNER. I think these charts should be put into the record.

(The charts referred to appear on pp. 822–823.)

Mr. SCHENKER. I will get reduced copies of the large ones and introduce them also.

Will the committee hear from Mr. Vass now? That will finish all our statistics. He will not take more than 15 minutes.

Senator WAGNER. All right.

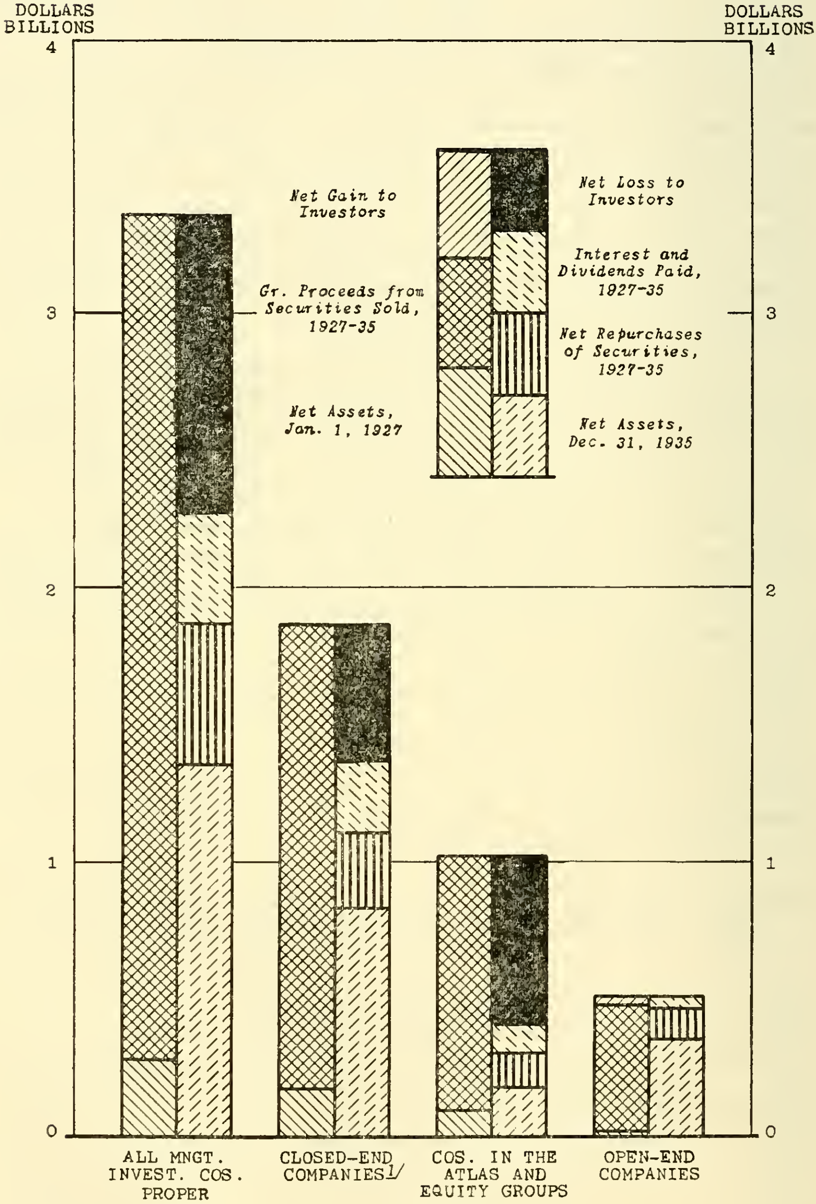
STATEMENT OF LAURENCE C. VASS, STATISTICIAN, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER (chairman of the subcommittee). All right, Mr. Vass. Will you give your full name, please?

Mr. VASS. My name is Laurence C. Vass and I am one of the statisticians who worked on the S. E. C.'s study of investment companies. My particular job was to prepare the study of performance, about which Mr. Bunker told this committee a few things, not all of which were highly flattering to the study. Among his less subtle criticisms was the blunt statement: "The whole thing was invalid."

That is a very serious challenge, and I have been very busy during the past 10 days examining the basis for his claim. The facts we have uncovered show that it would be very unfortunate if this committee were left with that impression; since the facts, as we see them, do not verify this assertion.

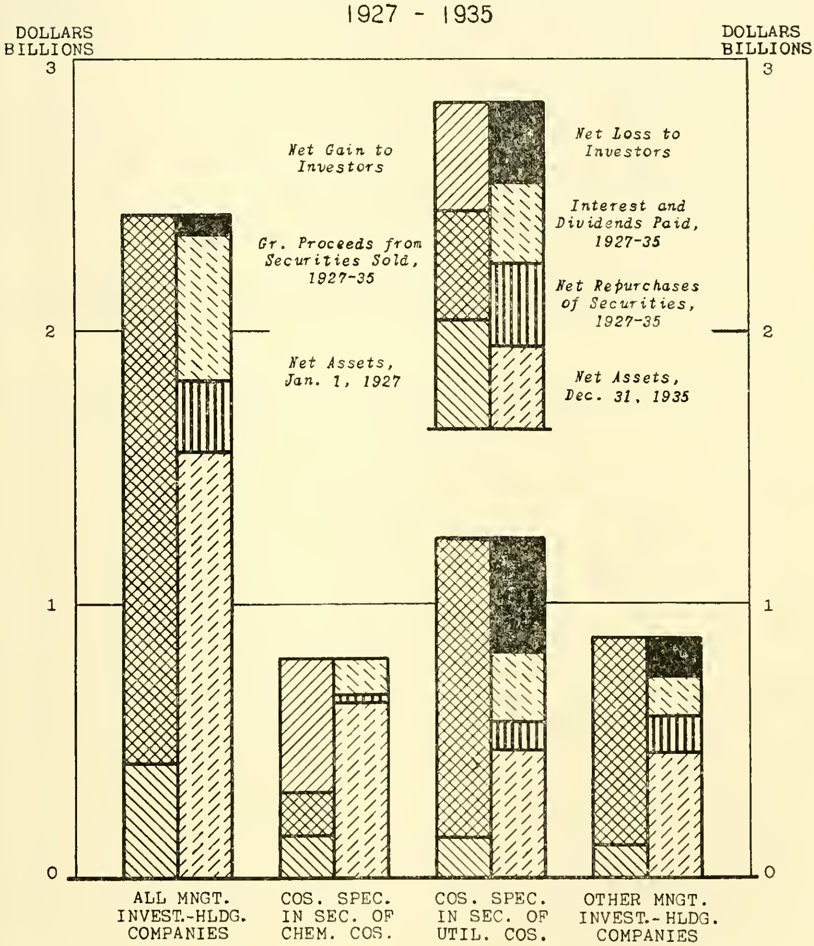
INVESTORS' EXPERIENCE IN MANAGEMENT
INVESTMENT COMPANIES PROPER
1927 - 1935



1/ Other than those in the Atlas and Equity groups.

DS-1120

INVESTORS' EXPERIENCE IN MANAGEMENT
INVESTMENT-HOLDING COMPANIES
1927 - 1935



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It is important to note that Mr. Bunker did not attack our method of measuring the performance of investment companies, nor did he attack the actual results obtained for the companies included in the study. He did not challenge our figures which show that 49 large closed-end companies which survived through 1935 actually lost about 30 percent of their fund over the 1930–35 period and about 45 percent of their fund during the period from 1930 to 1937. He did not challenge our statement that the entire body of investment companies undoubtedly performed worse than this sample of the best companies, picked because they had at least $5,000,000 or more left at the end of 1935. He did not deny that these companies performed no better than the Standard Statistics index. The sole point of attack was the conclusion we drew from this last comparison.

Thus, Mr. Bunker apparently agrees with us that even this hand-picked sample of good companies lost a substantial proportion of their funds during this period; but he does not exactly agree with our evaluation of this loss. We found that this loss was as great as the loss experienced by a certain type of unmanaged fund—a common-stock index—and, therefore, concluded, to quote Mr. Bunker, that—

> the results the managements of investment companies had achieved is exactly nothing, that one would have done just as well had he bought a package of securities as represented in well-known indexes and carried them throughout this trying period.

Mr. Bunker, however, cognizant of these same facts, informed this committee that "the record of these companies over the depression period has been little short of remarkable." Furthermore, Mr. Bunker found our conclusion unrealistic, giving no true picture whatever of the actual comparative performance achieved. What in brief were his objections, as presented to this committee?

In the first place, he claimed that this particular index cannot be considered an unmanaged fund. In the second place, he said that it would be impossible to set up a fund to follow this index without incurring tremendous costs through constant shifts in the portfolio. In the third place, he claimed that there are only two other ways of approximating the performance of the index, both of which would involve extremely large losses, with the result that the investor in this fund would fall far behind both the alleged performance of the Standard Statistics 90 Stock Index and the average performance of the investment companies included in the study. In short, he cannot accept our conclusion because he feels that it is unfair to investment companies to use the index in this manner. Let us examine his criticisms.

First, we have his contention that the index represents a managed fund. Let us suppose, for the sake of argument, that there actually were 333 rights offerings during this period, and that it actually would have required 29,970 market operations to keep up with the index. Would this make it a "managed" fund, in any real sense?

Our answer is that investment trust managers do little managing if that's all the managing they do. There is not the slightest element of judgment involved in making the portfolio adjustments necessitated by changes in the index. Suppose, for example, a company retired half of its common stock. It doesn't require an expert mathematician, a highly paid market forecaster, a research department, a statistical department, or mahogany furniture to figure out how much of this particular security to sell and how much of other securities to buy.

The Standard Statistics Co.—makers of the index—will gladly furnish without cost the simple mathematical formula whereby the necessary changes are determined. A course in high school algebra and a high degree of honesty are the only requirements for managing the index fund. We cannot find management where there is no judgment or discretion. If this be management, then the trustees of fixed trusts are entitled to as much remuneration as the managers of management trusts. If Mr. Bunker is willing to agree that in actual operation no more than this has been involved in the management of the companies which we compared to the index, then we would admit, not that both were managed but, rather, that both were unmanaged, the one with relatively low cost, the other with extremely high cost, given the degree of management.

So much for the argument that the index would constitute a managed fund. What of the claim that there were so many capital changes during this period that the cost of following the index would be prohibitive? According to Mr. Bunker, the Commission overlooked the fact that the entire portfolio might have to be turned over every time there was a capital change in one of the 90 companies. We were aware of this fact. Mr. Bunker laid particular stress upon rights offerings, which require new money, or a turn-over of the portfolio. We were aware of this fact. Mr. Bunker informed this committee that—

> there were 333 occasions during the period between 1927 and 1939 on which it was necessary to take up rights to purchase stock as offered.

We most certainly were not aware of that fact.

It is no exaggeration to say that we were dumfounded to learn from Mr. Bunker that there were exactly 186 offerings by means of rights between 1930 and 1935, the period upon which we primarily based our conclusions, and during which we were reasonably certain that there were few important capital changes. This is an average of two offerings per stock—a very high figure. If there were 186 rights offerings, just imagine how many capital changes of all types there must have been, and how profound an effect capital change must have had upon the index which we used so naively.

However, I will be frank and admit that we were immediately skeptical of this figure of 186. So we looked into the matter. A hasty perusal of the financial manuals disclosed that there were only 9 or 10 rights offerings recorded during the 1930–35 period. Surely, this could not be correct, since the difference between 10 and 186 is all of 176. So we asked the Standard Statistics Co. to estimate for us the number of rights offerings affecting the index during this period. Now, it is true that our own figure was not verified by the Standard Statistics Co., since they informed us that there were but 4 such offerings; but we are still a long way from verifying Mr. Bunker's figure of 186.

However, we immediately concluded that Mr. Bunker was perhaps speaking loosely and he really meant capital changes of any kind when he spoke of 186 offerings by means of rights. So we asked the Standard Statistics Co. for their estimate of the number of capital changes of any kind during this period which could have had some effect upon the index. They told us that there were 6 substitutions (which we had recorded), that there were 4 rights offerings, that there were 19 cases of capital acquisitions requiring the issuance of additional stock,

and that there were 21 changes of 1 percent or more resulting from the retirement of treasury stock. Thus, there were 44 changes in all which might have had some slight effect upon the index.

By now we had begun to suspect that the 186 rights offerings and the 16,740 market operations recorded by Mr. Bunker may have had little net effect upon the index, after all. As a matter of fact, when we originally decided to use the Standard Statistics index we gave some thought to this problem. We noticed that there were few actual substitutions. We looked over the 90 companies, and we concluded that capital changes would not be of material importance. We were encouraged in the decision to use the index by the knowledge that we were setting no precedent in so doing, since several financial publications utilize stock indexes in just this way. We submitted the study to Prof. E. B. Wilson, of Harvard University, who wrote that it was a "sound and thorough job." Furthermore, Mr. Alexander Sachs, vice president of the investment company of which Mr. Bunker is the executive head, was kind enough to permit us to examine a study prepared in 1937 by Lehman Corporation in which the performance of investment companies was compared to the Standard Statistics 90 Stock Index—the same index we are using. Since nothing was said in that study about the impropriety of such a comparison, or its unreality, we felt even more that it was safe to go ahead.

Therefore, the sweeping attack by Mr. Bunker on this index was quite unexpected. Apparently, we were entirely wrong in our belief that capital changes were not of much importance, and a great deal of money would be needed to follow the index.

There was a very simple way to find out whether we or Mr. Bunker had been misled.

We looked at the manuals and found that about 27 percent of the stocks, exclusive of four stocks involved in substitutions, had the same amount outstanding in 1929 and 1935. Forty-one percent of the issues increased the amount of outstanding shares over the period and 32 percent of the issues decreased the amount outstanding. Thus, new money could be required for only 41 percent of the issues. It is perhaps understandable that Mr. Bunker stressed rights offerings and acquisitions of property when he pointed out to this committee that it required an "inexhaustible supply of money" to follow the index. To emphasize the fact that money was made available every time the number of outstanding shares was decreased would not strengthen his case against our index. Furthermore, it appears that Mr. Bunker, in describing to you the number of capital changes and the necessary market operations, did not mention the possibility of capital changes offsetting one another. If his 186 changes were all increases, the amount of new money necessary to follow the index might be a very large figure; if these changes offset one another, it may just be that a supply of liquid funds somewhat less than "inexhaustible" might do the trick. This also can be determined very simply.

For this, we figured out just how many shares were outstanding for the index stocks at the end of 1929, and then we figured out how many shares these companies had outstanding at the end of 1935 and also at the end of 1939. We left out the companies involved in substitutions, because they would distort the picture. We found that the amount outstanding in 1935, after adjusting for rights, was a mere 3.5

percent higher than the amount outstanding in 1929; and we found that the amount outstanding at the end of 1939 was only 4.5 percent higher than the amount outstanding at the end of 1929—10 years earlier. Thus, the net effect of the 186 changes recorded by Mr. Bunker was not very substantial, averaging an annual increase of about one-half of 1 percent.

So much for the actual importance of these 186 changes and 16,740 transactions. In terms of total trading, our index would require very much less turn-over than is typical of management investment companies. Still, we are forced to admit that this increase, small as it is, does require adding funds to the original portfolio if the fund is to be maintained without effecting transactions in all 90 stocks. Mr. Bunker told you that there were no idle funds and that the company would be forced to liquidate a small fraction of each stock in order to make these adjustments. This is true, he said, because "dividends paid do not enter the construction of the index." Now, Mr. Bunker says in another place that he has "examined with care these studies of performance." Despite this, he did not notice that we did include in our performance figures the dividends paid by investment companies and the dividends paid by the 90 stocks making up the Standard Statistics index. Thus, we do have a fund available for making the relatively small adjustments required by these capital changes, while avoiding the transactions totaled by Mr. Bunker. The dividends accruing to this fund averaged 4 percent or more annually. Now, 4 percent is at least equal to one-half of 1 percent, on the average at least, and therefore reinvested dividends would be ample to take care of all capital changes. Thus, we are spared the 16,740 transactions of Mr. Bunker, and a fund can actually be invested in the index.

However, we can settle this controversy in a very simple fashion, if the foregoing facts do not sufficiently dispose of Mr. Bunker's contentions. If we are correct in our belief that the capital changes during this period were entirely unimportant to the actual performance of the index, that the "management" of the index over the period was completely negligible, then it should be true that the performance of a fixed fund would be practically identical with the performance of the index. Mr. Bunker told this committee that we probably had this erroneous idea in mind. We did have; and we tested it. We invested a fund in these 90 stocks in proportion to the market value of each of the 90 stocks on December 31, 1929. In order that there could be no claim that retroactive judgment was exercised in the substitution of securities, we eliminated four stocks which were replaced by other stocks some time during this period. We were left with a portfolio of 86 common stocks as of the end of 1929. At the end of 1935 we evaluated exactly this portfolio, and obtained the performance record of a fixed fund, without a single change of any kind during a 6-year period. We even ignored the few instances of valuable rights, with the result that the performance of this fund must necessarily be worse than the true performance of the actual unmanaged fund. Even so, the value of this portfolio at the end of 1935 was 62.8 percent of the 1929 value, whereas the 90 stock index which was used in our study and which was attacked by Mr. Bunker as being impossible to achieve, wound up the same period with a figure of 62.5 percent, nearly 1 percent less than the completely unmanaged fund.

This same unmanaged fund at the end of 1939, a 10-year period without management of any kind and without obtaining the benefit of valuable rights, stood at 58.3 percent, as compared to the value of 59.2 percent recorded by our 90 stock index. The difference of less than 1 point in favor of the actual index is certainly little more than the value of the rights which were ignored in our comparison. Therefore, we are perfectly willing to substitute this index over the 10-year period for the 90 stock index; and it goes without saying that any conclusion which we drew from the 90 stock index may with equal propriety be drawn from this fund, which even Mr. Bunker must admit is completely unmanaged.

Time did not permit us to extend this study over the whole of the 1927–39 period. We did, however, analyze the fate of a fixed fund invested in the Standard Statistics 90 stocks over the 1927–29 period, during which relatively large capital changes took place. The performance of this fixed fund was 155.7 percent as compared to the figure of 159 percent which we used in our study. Thus, the difference is but 2 percent, hardly enough to invalidate the S. E. C.'s study of performance, in view of the fact that we ignored valuable rights in constructing the completely unmanaged fund.

So much for Mr. Bunker's second point—that it would be impossible to achieve the Standard Statistics results without incurring heavy expenses. The studies just presented should suggest that there is little merit in this line of attack. So we come to Mr. Bunker's third criticism of the index—that there are only two ways of approximating the performance of the index, both of which result in far greater losses than we showed over this period.

Now, how could Mr. Bunker obtain these losses, in view of the fact that we have just shown that capital changes were of no real importance, and that you could do just as well as the index by ignoring all capital changes?

The point is highly technical. If you look at Mr. Bunker's table I, you will note that he gives performance figures for the 3 industrial components of the 90-stock index—one figure for the 50 industrial stocks, 1 for the 20 utility stocks, and 1 for the 20 railroad stocks—all included in the index. These values are averaged in a certain way to obtain the figure Standard Statistics gives for the 90-stock average. In combining these 3 groups, the industrial stocks are from 4 to 5 times as important in the final result as either the rail or the utility stocks. This is because they are weighted on the basis of the number of shares outstanding in the 3 industries, and there are many more shares outstanding for industrial concerns than there are for railroads or utilities. By combining these 3 indexes in the proportions given by the Standard Statistics Co., you can obtain the values given by Mr. Bunker for the 90-stock index which we utilized.

We tried to derive Mr. Bunker's 90 stock values from the 3 indexes he himself presented to the committee. We were unable to do so. Then we put a mathematician on the job and told him to find out for us the basis which Mr. Bunker must have used to obtain figures so contrary to our study. His answer is very interesting.

Apparently, Mr. Bunker did not follow the correct procedure in making the approximations to the index which were presented to this committee. He apparently decided to make the railroad and utility stocks nearly as important in his fund as the industrial stocks.

Now, it just happens that utility and railroad stocks fared very poorly over this particular period, as compared to the industrial stocks, as can be seen from the figures presented by Mr. Bunker. Any index which exaggerates the influence of railroad and utility stocks will tend to do poorly as compared to the Standard Statistics index, and this apparently is the reason why Mr. Bunker's approximations show such very poor results from the attempt to invest a fund in the 90 stocks.

Actually, if you treat Mr. Bunker's indexes for the three different groups in the same manner as Standard Statistics Co. treats their indexes, and as we treated our index, you will find that the index we used lost more money than either of Mr. Bunker's indexes, over the period from 1929 to 1935, to 1937, or 1939—exactly opposite from Mr. Bunker's contention! Thus, there can be no question that we were being very fair when we used the Standard Statistics index and avoided all the trouble which Mr. Bunker must have experienced in constructing these indexes which actually did better than either our index or investment companies.

So much for the attack upon our way of doing things, as found in Mr. Bunker's statement. In addition to criticism of our study, Mr. Bunker presented to the committee certain constructive comparisons which, he felt, "view this entire business in some realistic setting." In the first place, it seemed to Mr. Bunker "to be particularly fitting to make a study of all issues other than investment companies which were offered and sold in the year 1929 and trace through their behavior in comparison with the behavior of the portfolios of investment companies."

Presumably, this study avoids the incomparabilities and distortions which are alleged to be found in the S. E. C.'s approach, and constitutes a thoroughly fair comparison. We agree with Mr. Bunker that the results of this study are extremely interesting. We also feel that the method employed in making this study is extremely interesting. What was done?

He included the selling load in the loss for noninvestment companies but omitted this loss in calculating investment company performance; he measured the loss in investment companies, not from all companies, but from the experience of 49 hand-picked companies which performed far better than the general run of investment companies; and he used market values in figuring the noninvestment company loss in 1935, and asset values for investment companies. The biggest bias was in using the 49 company figures; but when I tell you that the common stock of the Lehman Corporation, admittedly one of the companies with the best performance record, was selling at a discount from asset value of about 31 percent at the end of 1939, you can see how much difference it would make to Mr. Bunker's comparison if he used market values instead of asset values for investment companies.

In view of these incomparabilities and distortions, we feel that no significance can be attached to Mr. Bunker's results. Instead, we propose to submit a comparison which we deem to be correct, now that Mr. Bunker has pointed out the usefulness and validity of comparing all investment companies organized in 1929 with all other issues brought out in 1929.

In contrast to Mr. Bunker's figures, which show that the investment companies lost a mere 44 percent over this 6-year period while all

common stocks of other types of companies brought out in ... st 67 percent of their original cost to investors, we can inform ... mittee that the investors in the investment companies org ... in 1929 had lost 64.3 percent of the fund they invested by th ... of 1935, without taking into account the factor of discount from asset value. If we adjust for the discount from asset value, then this loss would exceed 67 percent, leading to the conclusion that investment companies organized in 1929 were certainly no better and quite possibly were worse than all other common stocks issued in that year.

The second comparison made by Mr. Bunker was to a list of 50 stocks recommended on September 30, 1939, by one of the best-known investment rating services, whose recommendations he regarded as representative of sound and experienced judgment at that time. Mr. Bunker informed this committee that the fund invested in the 50 stocks recommended by this agency suffered a loss of more than 50 percent between the end of 1929 and the end of 1935, while the average of investment trust portfolio valuations at the end of 1935 was 69 percent. He went on to tell this committee that investment company portfolios preserved 44 percent more of their assets than if they had been composed entirely of these recommended and leading stocks.

I believe that the evidence which I have presented to this committee indicates that this comparison may be prejudiced somewhat in favor of investment companies. You will note that Mr. Bunker again uses the performance of 49 leading closed-end companies as representative of all investment companies. If all such companies were included, the loss would certainly have been greater than 50 percent. Furthermore, an examination of the list of 50 stocks used in this comparison gives us a very good clue as to the source of the relatively large loss experienced by this list of securities. Included within the 50 were 5 bank stocks, 12 utility stocks, and 15 railroad stocks; that is, nearly two-thirds of the issues belong to industries which performed very poorly over this particular period. Railroad stocks, for example, constitute 30 percent of the number of issues, an importance never approached in the portfolio of investment companies.

Now, if you wanted to select in 1939 a list of stocks which would perform very poorly between 1929 and 1935, it is quite clear that you would avoid as much as possible industrial stocks and would pick a list of stocks which would include a high proportion of railroad, utility, and bank stocks. It would be virtually impossible to pick a diversified list of these stocks which would perform as well as the better investment companies, which invest from two-thirds to three-fourths of their fund in industrial securities. We feel that these particular figures prepared by Mr. Bunker do not throw much light upon the performance of investment companies since, on the one hand, the figure used by Mr. Bunker does not truly reflect investment company experience and, on the other hand, there is considerable doubt as to the unprejudiced nature of the list of 50 stocks he used. We are convinced that the comparison to the Standard Statistics 90 stock index is completely fair and realistic and that there are adequate grounds for preferring its use to either of the comparisons prepared by Mr. Bunker.

So far we have devoted this discussion to the points presented to you by Mr. Bunker. Now, there were quite a few points about our study which Mr. Bunker did not mention; and I should like to call

to t' , ' .ittee's attention a few of the more positive, constructive res' ' hed from this study.

. he companies included in our study, the best record was an a ' tion of 323 percent, experienced by an open-end company, which s included for the entire period from 1927 to 1937. The next best company, with an appreciation of about 184 percent, was included only for the 1933–37 period—a relatively short time. Two other companies had an appreciation of almost 100 percent, one of which was formed in 1927 and the other in 1933. At the other extreme, we find 7 of the 38 closed-end companies experiencing net depreciation of 40 percent or more, by the end of 1937.

Of the 38 closed-end companies we analyzed through 1937, 25 showed a net loss up to 1937, while only 13 showed a gain over the period of their life. As would be expected, the record of the younger open-end companies is better, only 10 showing depreciation through 1937 and 25 showing gains.

The fact that approximately half of the companies had intact their investible fund at the end of 1937 is not as favorable a picture as might at first sight appear. Contributing to this result are all the distributions—interest and dividends—received by the security holders of these companies. This means that the performance record of no net loss over the period reflects portfolio losses about equal in amount to the return actually paid to investors. If we set as a standard an annual return of 4 percent for the period of the company's existence, we find that only one of the 38 closed-end companies performed sufficiently well to retain its capital without loss and yield a 4 percent return to its security holders, while 15 of the 35 open-end companies did sufficiently well to yield 4 percent or more. Fifty-seven of the seventy-three companies included in the study were unable to return as much as 4 percent per annum to investors through 1937.

The evidence indicates that investment companies are unable to make money on their investments year after year. In years of rising common stock prices, they do make money; but in years of declining stock prices, they lose about as much as they make in good years. Over the period we studied, the management investment companies whose performance we included just about broke even on their investments, when the return on these investments is taken into account. Furthermore, we found that individual managements were quite unable to maintain a consistently good record over several years.

Since actual performance depends so much upon the major swings in security prices, the mere statement that investment companies made or lost money over a particular period does not throw much light upon the "expertness" or skill of the management of these companies. The great majority of these companies was organized to invest in common stocks, and the investors who purchased these securities were generally aware that their money was going into common stocks; and thus we may assume that most of them realized that they were exposing themselves to the risk of capital appreciation or loss. If these investors were interested as much or more in capital gains as in steady income, the actual record must be evaluated with this in mind.

One such comparison is obtained through the use of an index of leading common stocks. Mr. Bunker dissenting, the performance of such an index reflects an unmanaged fund, invested in a diversified

list of widely held common stocks of the sort which actually bulk large in the portfolios of the investment companies in question. The changes in the stocks making up the index occur but infrequently, and new stocks are selected not for their investment appeal, but simply upon their status as leading stocks. There are one or two things about this index which Mr. Bunker did not discuss.

In the first place, the index always remains 100 percent invested in common stocks, whereas the investment company is free to keep its fund in cash, in bonds, preferred stocks—any way it pleases. Thus, the investment company can perform better than such an index, that is, exhibit its expertness, by shifting its funds into common stocks, when they are a good investment, and getting out of common stocks prior to a major decline in stock prices. A trust that remained 50 percent in cash throughout the post–1929 depression would, of course, perform much better than the index, unless the remaining investments were extremely bad.

In the second place, "expert" management implies the selection of better performing stocks for the portfolio than the investor would be likely to select. In contrast to the index, which contains but 90 stocks, the combined portfolios of these investment companies contained between 1,000 and 2,000 different common stocks. Presumably, management decided upon the selection of this great variety of stocks because these were, in their judgment, better investments. If they were not better investments than a handful of most widely held stocks, it is indicated that the judgment of management is no judgment at all, or that the many abuses of unregulated management more than offset their native good judgment. In either event, it seems reasonable to say that no management can claim to be "expert" or deserving of much compensation if its performance is much worse than the performance of an unmanaged index. We may allow a percent or so in favor of management, since the index is not charged with management's expenses, and still justify the comparison.

Analysis of the annual record shows that investment companies managed to lose less money in bad years than the index lost, but failed to make as much as the index stocks in good years. Specifically, the companies performed better than the index in 1929, 1930, 1931, 1932, 1934, and 1937, all years of declining prices; and they performed worse than the index in 1927, 1928, 1933, 1935, 1936, and 1938—years of rising prices. Over the 1930–35 period, closed-end companies performed exactly the same as the index, and 12 open-end companies performed slightly better than the index. These figures relate only to our hand-picked group of companies, and not to all companies. Over the 1927–37 period, 33 companies out of 85 managed to perform better than the index over their period of existence, and 52 companies, or 61 percent, performed worse than the index.

The general conclusion is that these management companies are unable consistently to "beat the averages." The fact that they do better in years of declining prices and worse in years of rising prices suggests that the decision to make investments other than common stocks is an important factor making their performance as good as it is. In the post-1929 depression, for example, a number of companies had only 50 or 60 percent of their fund in common stocks, and consequently performed much better than the index.

If we compare investment-company performance to the performance of a combined index of common stocks, preferred stocks, bonds, and cash, represented by indexes, and blended in the proportions characteristic of the actual portfolios of these companies each year, we can eliminate this aspect of the investment policy and find out whether skill was exercised in the selection of individual securities. If management does no better than such a combined index, it means that there is either no extraordinary skill in the selection of investments or that the money gained through clever investments is somehow dissipated.

We found that performance of this combined index over the 1930–35 period was some 30 percent better than the performance of the investment companies we treated. While actual figures are not available for the period subsequent to 1935, it is quite certain that the average company performed considerably worse than the securities in these indexes over the 1927–39 period.

Given these facts, we were led at the time of making our study, to the following conclusion: "Using the 90 common-stock index as a basis of comparison, the management of the typical investment company made no substantial performance contributions in the typical year to the investors in these companies." We see no reason to change this conclusion.

Thank you.

Senator WAGNER (chairman of the subcommittee). Thank you very much.

We adjourn now until tomorrow morning because the full committee has a very important meeting this afternoon, which will probably take a good part of the afternoon.

Will you gentlemen be prepared tomorrow morning at 10:30?

Mr. SCHENKER. Thank you, Senator.

(Thereupon, at 1:15 p. m., an adjournment was taken until tomorrow, Thursday, April 25, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

THURSDAY, APRIL 25, 1940

UNITED STATES SENATE,
SUBCOMMITTEE ON SECURITIES AND EXCHANGE,
OF THE BANKING AND CURRENCY COMMITTEE,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Herring, Townsend, and Frazier.

Senator WAGNER. The subcommittee will come to order. Mr. Bane.

ADDITIONAL STATEMENT OF BALDWIN B. BANE, DIRECTOR OF THE REGISTRATION DIVISION, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. BANE. Mr. Chairman and Senator Frazier: First, I would like to make two or three corrections in the testimony I gave the last time I appeared before you. I did not have an opportunity to go over it carefully enough before it had to be returned for printing. There are two or three errors in it.

First, on page 137, next to the last paragraph on that page, the transcript reads:

> This one man who had a share at $55 now finds two shares in at $55.

The first $55 there should be $59.

On page 140, about midway of the page, I said, or the transcript shows that I said:

> Now, granted, which we do—

Mr. Chairman, you will see it in the paragraph beginning "On September 11, 1939."

Senator WAGNER. Yes. You may go ahead.

Mr. BANE. Now, the very next sentence, about the middle of the page:

> Now, granted, which we do, that September 5 was an unusual day, no one can contend that the market fluctuations on September 11 and September 19 were in any way abnormal. As a matter of fact, over the past 9 years the Dow-Jones industrial averages change more once each 3 weeks than the changes in the market of September 11 and September 19.

I was in error, or at least I think that gives an erroneous impression. First, it whould be 6 years instead of 9 years; and, secondly, that should read:

> Once each 3 weeks on the average.

I think the statement as contained in the committee print indicates it changed every 3 weeks that much, which is not true.

On page 142 of the committee print, right at the bottom of the page, the last sentence on the page, reads:

> Of course, on days like September 5 you could buy the shares, pay the full load, sell them back almost immediately, and still make a substantial profit without any chance of loss except to the trust.

That statement implies that you could do that with all trusts. It is not true that you could do it even on that day in the case of all trusts, because portfolio values did not advance sufficiently. That statement is true with reference to many of them, but not with reference to all of the 78 of which I was speaking.

Senator WAGNER. All right, Mr. Bane.

Mr. BANE. When I appeared before you a few days ago, I attempted to explain the two-price system used by most open-end management type investment trusts in selling their shares or interests and the effects thereof on the trust and the investor.

I evidently was not as successful as I hoped I might be, for apparently the president of the distributor for the largest of these trusts, who was presented to you as the expert in such matters, doesn't understand it even after my explanation and his more than 15 years in the business.

I commented on the evils of the so-called two-price system employed in the day-to-day sales of the securities of these trusts which, as I explained, resulted in a cumulative dilution of the trusts, a dilution from day to day, from year to year, particularly in rising markets.

I submitted certain statistics compiled from the answers to questionnaires sent out by my division of the Securities and Exchange Commission to investment trusts of this type, that we knew were actively engaged in selling their securities in September 1939.

I tried to make it clear that the comments I was making upon the evils of this 2-price system applied generally to trusts of this type. I stated three or four times during the course of my remarks that more than 60 of the 78 trusts which were active not only allowed the interests of their existing shareholders to be continually diluted but that the 2-price method to which this dilution may largely be attributed was used by such trusts as one of their principal selling arguments.

I said:

> The theory back of these trusts is that the new member should pay for his share an amount equal to the proportionate equity of existing shareholders at the time the new member comes in.

To phrase this theory somewhat differently: The existing shareholder has already an interest in securities in the portfolio of the trust; the new shareholder puts in cash which cash when invested in portfolio securities certainly should not reduce the existing shareholders' interest. In other words, when he buys in, if you will come down to what actually should occur, the new shareholder should get as much proportionate interest in the trust as his money buys of the portfolio securities after they are taken in.

Senator WAGNER. And he gets more sometimes, does he not; I mean the new shareholder?

Mr. BANE. He may, if the market is not declining, and very few shares are sold in a declining market. About 90 percent of the sales are made in a rising market.

Senator WAGNER. But the fund did not get all it should get.

Mr. BANE. That is right, the fund did not get what it should get.

Senator WAGNER. That is what I meant.

Mr. BANE. The fund cannot and does not invest money it receives from sales of shares at the very moment the shares are sold. It does not even get the money at that time. It cannot invest the money the moment it receives it, either, as a usual proposition, but all these trusts, certainly those of the better type, boast that they keep in a fully invested position; that is, that they do not gamble on the market or bet against the course of the market. If instead of investing the funds at approximately the time they are received it holds them then it becomes not an investment fund but a gambling fund or vehicle for betting against the market.

Senator WAGNER. Let me see if I can make myself clear. I hope I did not misunderstand the proposition. Let us say that the price was fixed on the morning, or the night before, and during the day the market goes up and yet the price which was fixed in the morning is still the price at 2 o'clock in the afternoon. Is that it?

Mr. BANE. At 12 o'clock at night, too.

Senator WAGNER. I mean where you are able to buy.

Mr. BANE. You can buy at 12 o'clock at night.

Senator WAGNER. So if I buy at that particular time on a rising market I get a greater interest in the fund than really I am entitled to, isn't that so?

Mr. BANE. Than your money can duplicate in the fund.

Senator WAGNER. Than my money can duplicate in the fund; yes.

Mr. BANE. Yes; that is it.

Senator WAGNER (chairman of the subcommittee). You may proceed with your statement.

Mr. BANE. I attempted in no way to say how such trust shares should be priced and should be sold and I did not intend to suggest or imply any such thing in my previous statement. I intended only to show how trust shares actually are priced and how they are sold and the effects thereof. I am not speaking for the Commission. To my knowledge the Commission has not determined how these shares should be priced and sold, nor does anything in the bill indicate any such determiniaton. And I have never heard the Commission discuss different ways of pricing; nor is there anything included in the bill, any proposal, as to how they should be priced. I presume if the Commission had had any such idea it would have made such suggestions to you for use in the bill.

In determining dilution, I took the difference between the known and established net asset value per share and the lower price at which the share was bought from the trust and multiplied it by the number of shares sold. This is the only practical method of determining that dilution.

Mr. Sanders and Mr. Traylor have indicated in their testimony that sales are made throughout the day. I believe that the committee has received an entirely erroneous and misleading impression from such statements. The cold fact is that the trusts which are diluted by this practice make sales in practically all cases at one time during the day to the distributor—always after a new price has been determined.

In order to clarify the two-price method, let me explain how trust shares are generally bought from the trust. The usual procedure is for the dealer or salesman upon receipt of an order to place it aside with other orders which he has or will receive. Near the close of the day the dealer or salesman generally will either send the orders in to the underwriter all at once, if the market is up, that is, if tomorrow's opening 10 a. m. price is to be higher, or conversely in the interest of so-called good execution if the price at 10 a. m. is to be lower, hold the orders over until the next day or some later day before sending them in to the underwriter so as to benefit his customer, or on occasion, himself.

Thus having determined the "proper time" to send the orders in or have them executed to the disadvantage of the trust because of the two-price system, he sends his orders en masse to the underwriter or distributor. The orders must reach the distributor before the new higher price goes into effect if advantage is to be taken of the existing lower price. The distributor or underwriter gathers up any orders received and closes with the trust, i. e., "sweeps" the new sales into the trust before the new price goes into effect if the market has risen, but if it has fallen, holds them until the lower price is effective and then sweeps them in, or holds them over another day or two, as was true in one case I told you of in my former testimony, to see what the price situation will be.

Orders, when filled, are filled all at once by the trust; sales are not made throughout the day by the trust, irrespective of the time when the dealer or salesman made the sales. In substance, the trusts open once a day to sell shares. If shares are selling for less than they are worth, the orders are "swept" in and new shares issued. Any shares sold by dealers, salesmen, and the underwriters before the next "opening" and "closing" are grouped and either swept in if the new price is higher or held back another 24 hours if the new price is to be lower and so forth, day after day. Do I make myself clear?

Senator Wagner. You say it is just sold once a day?

Mr. Bane. Yes; as a general rule.

Senator Wagner. Suppose I want to buy a share. Of course you understand that I do not know about these matters as you do. If I want to buy a share have I got to wait for a certain time?

Mr. Bane. You do not have to wait at all. You give your order to the dealer. We will say the dealer takes your order this morning at 11 o'clock. He will send your order in to the distributor some time after 3 o'clock this afternoon, after the two known prices have been determined.

Senator Wagner. Who is the dealer? Who do you mean by "dealer"?

Mr. Bane. The one who sold to you, for instance.

Senator Wagner. Where do I go?

Mr. Bane. You give your order to the dealer and get his receipt. Your order is sent in to the underwriter, the only one who can buy from the trust, as a general rule. The underwriter is the only one buying from the trust. He has that arrangement with the trust by which the trust agrees to sell to nobody but him. The dealer sends the order to him to be filled. Do I make myself clear?

Senator Wagner. Yes; I think you do.

Mr. Bane. The underwriter and the trustee each know what the old price is and what the new price to go into effect is. Thus there

are two known prices at the time the trust opens up and sells to the underwriter. There are two price make-up sheets before them with two different prices. The trust practically always receives less than it should. If the lower of the two prices is the new price to go into effect later, the trust sells no shares. The orders are held back for 24 hours.

Senator WAGNER. As I understand, I put in my order to the dealer.

Mr. BANE. That is right.

Senator WAGNER. At the higher price, I suppose, is it?

Mr. BANE. No. You put your order in, and——

Senator WAGNER (interposing). Just to buy?

Mr. BANE. No. If the price is determined, for instance, on yesterday's close, whatever that price was you buy so many shares at that price today. You give that order to the dealer, and we will say your order is for 100 shares at $5.60.

Senator WAGNER. And let us say that the next day it is fixed at $4.

Mr. BANE. All right.

Senator WAGNER. What do you pay?

Mr. BANE. You pay $5.60 unless, as some underwriters have worked it out with the dealer, you put your order in to buy 100 shares N. A. That "N. A." means just prior to the next advance. Or to hold them S. L. if the market is looking down. Or you can send in orders, as Massachusetts Distributors does, and have the order marked to be executed at the lower of two prices after the new price is determined. Then they will execute it at the lower price.

Senator WAGNER. One other question right there.

Mr. BANE. Am I making myself clear to you?

Senator WAGNER. Yes; let me go back to the $5.60. Let us say that I make no condition at all. I want 20 shares of some particular trust, and it is during the day that I put in my order, let us say at $5. Now, at that time you say the dealer knows the price, it having been fixed for the next day, and he knows that it will be $4? Without my saying anything else what does he pay?

Mr. BANE. He will——

Senator WAGNER (continuing). Does he pay $5 or $4. Does he give me the advantage of the lower price?

Mr. BANE. Many dealers do, but some do not.

Senator WAGNER. Does that mean that somebody else may make that difference?

Mr. BANE. There is the difficult thing under this two-price system. A dealer may very well protect his customer and give his customer the benefit of the lower price, the $4 price, let him buy at the lower price, hold back his order. And let us say that he does that for the benefit of that particular customer. He gets him in the trust, and he does it for the next customer, and when he does it for the benefit of the customer he is now selling he is diluting the interest of the man already in. In other words, he is working in favor of his customer then coming in but to the disadvantage of the one he has already sold to last month. The higher price in declining markets is not received to offset in some degree this lower price received in rising markets.

Senator WAGNER. Then it is not so simple, is it?

Mr. BANE. No, sir; I do not think it is. [Laughter.]

Senator WAGNER. All right; go ahead.

Mr. Bane. I said in substance in my previous statement that if there were a trust with one share of steel worth $55 in the portfolio and one investment trust share issued against it that the trust share would be worth about $55. I also pointed out that if during the course of the day the stock market rose on steel shares so that at 3 p. m. the steel share in the portfolio was worth $59, then the trust share would be worth about $59. I further pointed out that a man buying a steel share after 3 p. m. therefore, would pay $59. Furthermore, I said that investment trust shares are sold on an entirely different basis and that under the two-price system used by most companies a man could buy another trust share after 3 p. m. for only $55 when the outstanding trust share was worth $59.

Now, I stated that if a new share were issued by the trust after 3 p. m. for $55, when the outstanding share was worth $59, the trust was diluted or weakened $4 and that the old purchaser would lose $2 of the $4 appreciation which had accrued to his asset value. One trust share at 3 p. m. is worth $59. It is the only trust share outstanding. If the share of steel in the portfolio were sold the trust would have $59 cash. The trust share is, therefore, still worth $59.

Now, a second trust share is sold by the trust at 4 p. m. or 10 p. m. or 9:55 a. m. the next morning, for $55 when the one outstanding trust share is worth $59. The trust then has two shares outstanding with assets of $114, either a steel share worth $59 and $55 cash, or $59 cash if the steel share is sold and another $55 cash—in either event $114. If the second trust-share purchaser had paid $59 the trust would have had $118, but actually under the two-price system the trust only has $114.

This is not hypothetical or unreal: $114 divided by two makes each share only worth $57. You have two shares outstanding—each share is worth $2 less than it should be worth. If each outstanding share is worth $2 less than it was and should be worth, the trust is weakened or diluted $4. The dilution is $4. This is how we determined trust dilution.

And further, let us note the effect, or what really happens to the new purchaser who bought at $55 and was sold upon the representation that the interest that he was buying was worth $59. As I pointed out, as soon as his contribution was put into the trust or stirred in, as it is called, his interest was worth only $57, $2 less than he thought he was getting. Thus there is involved in such cases in addition to a dilution of the old shareholder, a deception of the new shareholder and a sale to him upon a represented value in excess of what his interest in the trust will actually be worth when his contribution is put in. Many of these trusts redeem shares presented during the day upon the basis of the net asset value determined at the close of that day, although the new offering price based upon this net asset value does not start until 10 a. m. the next day. In such trusts a person who bought a trust share at 3:30 p. m. for $55, could redeem the share almost immediately for $59. This leaves the old shareholder with assets of only $55; his whole appreciation is taken away and there are not enough assets left for him to redeem at the value he has the right to redeem at, namely, $59.

This is an accurate illustration of what actually happens in these trusts under this two-price system, the difference in particular cases being one of degree only caused by the size of the portfolio, the number

of shares sold, and the difference between the two daily prices. I explained that the two-price system was used by practically all open-end companies now selling and how, with the redemption provisions, in many instances, it resulted in providing one understanding the system, which few people do, a means for absolutely riskless trading to the detriment and further dilution of the trust and that some dealers and some insiders take advantage of it.

I told you that the trusts covered by our survey showed that from September 1 to September 22, 1939, of approximately 60 trusts, 35 reported paying out on redemptions $338,119 more than they received for the same shares which had been sold in September 1939. Total sales in the 3-week period aggregated approximately $24,000,000 and redemptions approximately $8,000,000 despite the bullishness of the market.

It seems fair to state that the heavy redemptions, in a bull market, were largely the result of profit-taking by persons not interested in investments. The uninitiated, primarily the small investor, did not realize his opportunity or take advantage of this opportunity for quick profit. On the contrary, the uninitiated who constitute the bulk of investors, probably believed that the trustees or fiduciaries would look out for their best interests. They pay a management fee for such service and the prospectuses imply that the trusts are run for the benefit of the investor.

Mr. Traylor said that I—

> cited the example of the shares of the open-end trust which on September 5 advanced in price from $5.60 to $6.70 and yet was sold to the public on the basis of a value of $5.60 even though their established and known value was $6.70 according to the S. E. C.'s testimony.
>
> It is upon this illustration that the S. E. C.'s case in the matter of so-called dilution was very largely based. With all possible emphasis, I should like to say that this illustration is completely irrelevant as far as 90 percent or more of the open-end industry is concerned. It is also probably the most extravagant example the S. E. C. could have used. To employ Mr. Bunker's well-conceived analogy, this is most certainly a specimen and an exceedingly rare one at that, rather than a run-of-the-mine sample.

I want to emphasize to this committee that that example was in no sense a specimen but was a sample. The extent of the dilution is a matter of degree, but the principle is the same. It was not by any means the most extreme example that could have been used so far as the difference between the known price and the price at which the shares were sold is concerned.

The difference in the illustration I used was $1.10; the difference in the case of Boston Fund, Inc., of Boston was $1.50 and in the case of Massachusetts Investors Trust of Boston $1.22. These latter two trusts are distributed by Mr. Griswold's company.

I had thought of giving you some examples but perhaps it would be better not to cite individual cases. I will simply say that this difference runs from $1.22 to $2.30 per share in some of the companies.

Mr. Traylor in his testimony criticized the method I used in determining dilution. He spoke of a purchaser buying a trust share at approximately 11 a. m. for $20 when it was worth $20.10, causing a 10-cent dilution for each share sold. He then said that if the market closed at 3 p. m. at such levels as to make the trust share worth $20.30, the S. E. C. contended that the purchaser should pay $20.30 and that there was 30 cents dilution per share.

The S. E. C. contends nothing. Mr. Traylor failed to continue this explanation through a 24-hour period and to tell you about shares sold by the trust after 3 p. m., which, as I previously explained, is practically always the case. When it was actually known that the per-share asset value of the portfolio was $20.30 and its shares were sold thereafter by the trust for $20 per share, there was a 30-cent dilution per share to the trust.

He left a very misleading impression when he intimated that a share in his trust was or ever has been sold to an investor at 11 a. m. by the trust. It never happened. Mr. Traylor's firm has the exclusive right to purchase from the trust and no individual can buy directly from the trust at 11 a. m. or any other hour. He also implied that the trust received the money at 11 a. m. the same day. It does not. Until very recently shares were sold once per day only by his three trusts—at approximately 10 a. m. each day—which was 43 hours after the market closed on which the price was based. The two-price system allows purchasers and traders a 43-hour lag after the market closes on which the price is based.

In most of these trusts, the insider and dealer does not have to pay the full load, but buys at a figure close to net asset value. Large purchasers often have the same advantage. If the market appreciation is in excess of the charge to such persons, they have a trading advantage not available to the general public who bear the full load.

It is true that in a large trust such as Massachusetts Investors Trust now is, and which has grown large while using this two-pricing system, the percentage of dilution resulting from this practice for any 1 day, however exceptional that day may be, seems small when compared with the total assets of such trust built up through many years of sales while using the two-price system.

Naturally the larger the trust, particularly as to number of shares outstanding and total assets, the smaller the percentage of dilution may be, but remember that this dilution on September 5 relates to but 1 day. The abuses from this practice go on day after day, month after month, year after year.

As I previously said, it is impossible to determine how much additional money would be in these trusts for investors if shares had not been sold continuously at a price below their known and determined value at the time of sale by the trust. We know that for 1 day in September in the case of Massachusetts Investors Trust it would have amounted to over $170,000 and for the 3 days of September 5, 11, and 19 it would have amounted to over $182,000.

While it may be true that the volume of sales by these trusts on September 5 would not have reached the proportions they did had the offering price reflected market appreciation, as Mr. Traylor indicated in his criticism of my previous testimony, it is true that had the offering price reflected the market appreciation there would have been no dilution, no matter how large or small the volume of sales. Furthermore, the old stockholders would have retained the full appreciation value to which they were rightfully entitled, and if no sales had been made the assets would have been divided among a smaller number.

Now I want to take some of the percentages and figures presented to you by Mr. Traylor, the distributor of the largest of the open-end investment trusts, an expert in pricing and figuring trust shares. He

testified, referring to dilution on September 11, and 19, 1939, and I quote:

According to the Securities and Exchange Commission testimony, total dilution on these 2 days was $176,000 for the industry.

Now this is most illuminating—in relation to the value of shareholders' interests (some $500,000,000)—

And, remember, that through here we are talking about hundreds of millions of dollars, at times. To continue the quotation:

the so-called dilution figure of $176,000 for the 2 days picked by the Securities and Exchange Commission amounts to 0.00035 percent, or about thirty-five one-thousandths of 1 percent. On an annual basis, this would come to about five one-hundredths of 1 percent—and if we double it to take care of a few semi-abnormal days, it's only one-tenth of 1 percent—and if we triple it to take care of a few more, it's still only fifteen one-hundredths of 1 percent.

That, gentlemen, by the direct process of employing the Securities and Exchange Commission's language and figures on a basis which has a significant meaning, is the so-called dilution problem in a nutshell.

I do not really know that I understand him. Does he mean—thirty-five one hundred thousandths of 1 percent which he has in figures or thirty-five one-thousandths of 1 percent as he has written it out, and by the way, he read it to you as thirty-five ten thousandths of 1 percent.

But let us assume that he meant the figure, thirty-five one-thousandths of 1 percent which is correct for $176,000 and $500,000,000. Now let us look at his next statement—"On an annual basis, this would come to about five one-hundredths of 1 percent." On an annual basis he means but one thing, that is, he assumed 300 sale days in a year and there being 2 days involved here in this $176,000 figure, he multiplied by 150 to obtain his annual basis, and what does he say it gives you? "Five one-hundredths of 1 percent."

Now, what actually is 150 times thirty-five one-thousandths of 1 percent—simple multiplication—it is 5.25 percent or 5¼ percent, just 100 times the percentage he told you, and what is it in dollars? 150 times $176,000 amounts to $26,400,000 which is 5.28 percent of $500,000,000.

Now, if we double it to take care of a few semiabnormal days, as he did, it is not one-tenth of 1 percent, but $52,800,000 or 10.56 percent, and if you triple it to take care of a few more days as he did it is not fifteen one-hundredths of 1 percent, but $79,200,000 or 15.84 percent.

I made very clear, I thought, in my previous testimony that I was talking about and giving you figures with reference to only those companies covered by our survey of the September situation—some 78 in number, of which approximately 59 diluted their trusts on September 11 and 19, and that the figures I gave you applied only to those companies. This, I thought, was very clear from my testimony. Therefore, the comparison of the dilution figures for only those 59 companies with the total value of shareholders' interests for all open-end companies as taken from Moody's Manual, many of which are not selling, is extremely misleading, unfair, and unjustified.

Let us make the same comparison as made by Mr. Traylor between the dilution on these days and the total value of shareholders' interests in these 59 trusts: Such shareholders' interests amount to approximately $408,854,314. The dilution figure of $176,000 for the 2 days compared with this, amounts to 0.043 percent. On an annual basis as used by Mr. Traylor, this would amount to $26,400,000 or 6.45

percent. Now, if we double it, as Mr. Traylor did to take care of a few semiabnormal days, it would amount to $52,800,000 or 12.90 percent; and if we triple it as Mr. Traylor did to take care of a few more, it would amount to $79,200,000 or 16.35 percent; and remember this goes on year in and year out.

To quote Mr. Traylor again—

That, gentlemen, by the direct process of employing the S. E. C.'s language and figures on a basis which has a significant meaning, is the so-called dilution problem in a nutshell.

When Mr. Traylor used as an example what he claimed to be the biggest open-end trust in America and figures percentage dilution per share of that trust on a basis of his having closed sales at 4 o'clock, it is no fair indication of what would have happened had sales at the old price continued beyond that hour.

The reason Mr. Traylor stopped selling at 4 o'clock on September 5 was because under his contract with his security holders he had agreed if the Dow-Jones industrial averages changed more than $5 in 1 day, he would stop selling. That day it changed more than $5. The reason for him making such an agreement was the disastrous dilutive effect he realized dilution had upon the trust when it went beyond that amount—if the change is 1, 3, or 4¾ dollars it is only a difference in degree.

On September 11, and September 19, he made no such stop nor effort to prevent sales. He continued sales under the two-price system because the Dow-Jones industrial averages did not change more than $5.

Mr. Traylor said that "any dilution that occurs (usually during the periods of violent market movements) takes place in spite of the precaution taken to avoid it." As a general rule there is no precaution taken by the open-end industry to avoid this dilution. Securities are deliberately and knowingly priced and sold upon a basis that can do nothing but dilute the interests of existing shareholders, and even in periods of violent market movements no precaution is taken, as a general rule, by these trusts to avoid dilution.

Specifically, these trusts not only took no precautions to avoid dilution of their shareholders on an unusual day like September 5, but on the other hand, as I before testified, many of them urged their dealers by telegram and telephone to greater efforts in making sales.

I should like to read two or three of the telegrams sent in September by this type of trust to its dealers:

New price 33.06, accepting orders old price 30.68 subject confirmation until midnight.

Another one:

Still accepting orders old price 30.68. Spare no effort. Will advise any change.

And I quote from another one:

Up 41 cents again. Moved up faster than Dow-Jones composite average due about 98 percent invested position with approximately 90 percent of assets in stocks that should benefit from European situation. If order placed before 10 a. m. Saturday extra 2 percent above regular compensation, equal to about one-fourth of load which means considerable saving to investors or an extra margin on trades for those interested in market at this time.

I will read another one:

> The new price will be $6. We will sell at $5.74 until midnight our time at this price—

That does not indicate that they were taking precautions to prevent the shareholders from being diluted on an unusual day like September 5.

The fact is that instead of making an effort to protect the interests of those whom they were supposed to represent in a fiduciary capacity, who paid them a commission in connection with the purchase of their interests, who were paying them a continuing management fee for looking after their interests, these fiduciaries and underwriters indulged in an orgy of selling with full knowledge that it was working to the detriment of their shareholders. They obtained individual profits from such sales at the expense of their shareholders. Furthermore, many of these trusts had stated in their prospectuses that if there were any unusual fluctuations in market values during a day they would stop selling or change the price in order to protect the interests of such shareholders, which is I might say, a direct admission that there might be injuries to the shareholders by not changing the price.

Senator WAGNER. Mr. Bane, perhaps this is the place where I should read a letter from Mr. Traylor in relation to the figures which you have just quoted and as to which he desires to make a correction. I received it yesterday, but I did not know that this matter was going to be referred to this morning. May I read it and then you can comment on it if you like [reading]:

> DEAR SENATOR WAGNER: If it is permissible, I would like to take this means of filing a correction of a misstatement in my testimony of Wednesday, April 17, 1940, before the subcommittee of the Senate Committee on Banking and Currency, on the subject of pricing, selling, and repurchasing shares of open-end investment companies.
>
> In my testimony I stated that the so-called dilution figure of $176,000 for the 2 days—September 11 and September 19, 1939—amounted to 0.00035 percent, or about thirty-five ten thousandths of 1 percent of the total value of shareholders' interests. Upon rechecking, I find that due to an error in transposing decimal figures to percent figures this is an inaccurate statement. The correct statement should read as follows: "In relation to the value of shareholders' interests (some $500,000,000), the so-called dilution figure of $176,000 for the 2 days picked by the S. E. C. (September 11 and 19, 1939) amounts to 0.035 percent, or about thirty-five one-thousandths of 1 percent."
>
> These figures are arrived at by dividing the amount of so-called "dilution" ($176,000) by the dollar value of shareholders' interests (some $500,000,000). The quotient of this division is 0.00035. Expressed in percent, it becomes 00.035 percent, or thirty-five one-thousandths of 1 percent.
>
> Although the margin of my error is rather large, I trust you will agree with me that the corrected figure of thirty-five one-thousandths of 1 percent is of such negligible proportions that it is of no importance as a factor affecting shareholders' interests.

Mr. BANE. I agree with all except the last sentence.

Senator WAGNER. The "negligible" part?

Mr. BANE. Yes, sir. Of course I did not know when I took these figures that you had anything of that kind. I was talking of Mr. Traylor's testimony as it was in the record.

Senator WAGNER. Now we have both sides.

Mr. BANE. Although Mr. Traylor criticized the selection of September 5 as being a highly abnormal day as a basis for selecting representative figures to illustrate dilution, it appears that that day

would be an excellent illustration of the actual practice of the managements of these trusts in giving effect to the representations and implications made to the investing public in connection with price changes. Of the 78 trusts answering the questionnaires, 43 had stated or implied in their prospectus that they would alter the price or stop selling upon an unusual market fluctuation.

Of the 78 trusts covered by the study to which I referred in my previous statement, approximately 60 did not change their price during the market day of September 5, 1939, and included in this 60 are Massachusetts Investors Trust, Boston Fund, and Supervised Shares, distributed by Mr. Traylor's company. While it is true that these three trusts did stop selling at 4 p. m. due to the limitation imposed on their method of offering, the dilution to these three trusts even with this limitation, amounted to $233,876 on that day. Suffice it to say that this was the only time in 15 years, so far as we have been able to learn, that Massachusetts Investors Trust stopped selling because of an unusual market upswing. There may be others, but, if so, I do not know of them.

Mr. Traylor would have you believe that the evils resulting from this two-price system occurred only in a fringe of the industry. This industry is probably peculiar among all those in this country. There is a fringe all right, but in this industry the fringe is the part that attempts to protect the interests of its shareholders. Of the 78 trusts, but a small number, specifically 8, made any real effort during this 3 weeks period in September 1939, to which I have referred, to prevent their shareholders' appreciation in value from being given away for the sake of increased profits to the distributors and managers through increased sales and resultant underwriting commissions and management fees. In other words, in this industry, you do not have to protect the industry from the fringe, but the fringe must be protected from the industry.

In an example that I gave in my previous statement, the value of each outstanding share in a trust rose from $5.60 to $6.70, but when the sales made on the basis of that rise were stirred into the trust, each share, both old and new, was worth only $6.04, causing a loss to the old investor in 1 day of approximately 66 cents per share, or 9.86 percent of his asset value which had accrued to him prior to the sales of the new shares. The investment trust to which I referred has never earned 9.86 percent net annually on the value of its assets in the course of its whole existence.

In my statement before you on April 5 I purposely, and I think properly, refrained from using names; however, I should like now, for the information of the committee, to show just what happened as a result of this two-pricing method in the case of three trusts as shown by the information furnished to us by those three trusts. Now, I am sure you know that Massachusetts Investors Trust, Boston Fund, and Supervised Shares are in the investment trust business as open-end management-type investment trusts and that Massachusetts Distributors, Inc., sells the shares of these trusts. Witness Secretary Adams, Dr. Sprague, Mr. Griswold, Mr. Traylor, Mr. Amory, Mr. Sanders, Mr. Curtis, Mr. Motley, Mr. Dewey, and others who have appeared before you as the representatives or on behalf of these trusts.

The total sales in the 1-year period from September 1, 1938, to August 31, 1939, by Massachusetts Investors Trust were $8,921,894. The total sales on 1 day, September 5, 1939, were $2,730,912. This means that the sales on that 1 day were approximately 92 times average daily sales during the subject year.

And that is in spite of precautions taken to prevent dilution of the trust.

In my testimony on April 5 I stated that the sales on September 5 for the industry were 83 times average.

Now let's take up the number of hours—two known prices exist for the shares of these companies. Prior to January 2 of this year—and Massachusetts Investors Trust has been in business for 15 years—there never was a time, so far as I was able to learn, when two prices weren't known or determinable for as long as 19 hours, with one or two exceptions. On September 5, 1939, two prices were available for only about 1 hour, as I previously explained. Of course on September 11 and September 19, which days we also covered in the questionnaire, there was no shut-off at 4 p. m. Two prices, known and determined, were held for 19 hours.

The information furnished by the questionnaire returns filed by Massachusetts Investors Trust indicates the following: The net asset value of each outstanding share at 10 a. m. on September 5, 1939, was $19.51. The underlying portfolio increased sufficiently in value, so that at 3 p. m. each of these same outstanding shares had a net asset value of $20.73. The trust sold 139,975 shares at $19.51 per share to Mr. Traylor's firm at a time when it knew that the actual value was $20.73 per share. Thus the trust received $1.22 less than actual asset value for each share sold to the underwriter or distributor. Principally because of this price attraction 92 times as many shares were sold as usual. The trust was diluted $170,789.

Now let's take September 11, 1939. The asset value per share at 10 a. m. was $20.86. The asset value of each of those shares at 3 p. m. was $21.17, or an increase of 31 cents per share. The trust sold 10,916 shares worth $21.17 per share to Mr. Traylor's firm at $20.86 per share, when they both knew that the asset value of the trust was $21.17.

Senator Wagner. What happened to those shares after they were purchased by Mr. Traylor's company?

Mr. Bane. He filled the orders that he had obtained during the course of the day.

The public had had 19 hours in which to purchase these from Mr. Traylor's firm at the lower price.

Now, let's take September 19, 1939. The asset value at 10 a. m. was $20.44 per share. At 3 p. m. these same shares were worth $21.05 per share. Thus Mr. Traylor bought these shares for 61 cents less than their actual value. The trust that day sold 13,220 shares to his firm and was diluted $8,064.

Senator Wagner. Do you happen to know what other shares were sold on that day?

Mr. Bane. What other companies sold shares?

Senator Wagner. No. You say Mr. Traylor's firm bought 13,000 shares.

Mr. BANE. Mr. Traylor was the only person that could buy from the trust; that is, his firm. And then he distributes as the distributor among the dealers who sold all over the country.

Let me briefly say that Supervised Shares on September 5 sold shares worth $9.93 for $9.41. On September 11, it sold shares worth $10.21 for $10.08 and on September 19 it sold shares worth $10.19 for $9.90.

As to Boston Fund, on September 5 it sold shares worth $15.75 for $14.54. On September 11 it sold shares worth $16.36 for $16.00 and on September 19, it sold shares worth $16.17 for $15.55.

I would like to read an extract from Massachusetts Investors Trust's prospectus, dated January 16, 1939, and used throughout last last year (reading):

> Since a new offering price is determined and known while the previous offering price is still in effect, the general distributor, dealers and investors may defer purchasing shares at the then effective price when it appears that the new price will be lower, and conversely, may purchase shares at the then effective price when it is known that the new price will be higher. All purchasers thus have and have had the opportunity of placing orders after there has been an increase in the net asset value of the shares and before the higher net asset value becomes effective, thereby securing the advantage of the lower public offering price then in effect. To the extent that the net asset value determined but not in effect exceeds the net asset value in effect, there results a diminution pro rata of the net asset value of the outstanding shares when the distributor places its order with the trust, which occurs immediately prior to the time when the effectiveness of the then net asset value and public offering price expire.

When Mr. Traylor says that they do not dilute, he must not be talking about a diminution pro rata of the net asset value. He admits that there is a pro rata diminution, but he denies dilution.

Approximately this same language appeared in the prospectuses of Boston Fund and Supervised Shares and a similar statement appears in the prospectus of practically all other such trusts. This explanation of dilution in such prospectuses is no hypothetical assumption or a mere theory, as Mr. Traylor says. It is a cold fact. I told you in my previous statement that certain companies told dealers how to take positions and execute orders in a manner that would result in diluting the trust.

Senator WAGNER. What is the point that is intended to be emphasized in that prospectus?

Mr. BANE. I am sorry if I read it too fast, Senator. But he intended to emphasize——

Senator WAGNER. What do they intend to convey?

Mr. BANE. I read it to you, Senator. What they intend to convey to tell their purchasers, those to whom they are offering, is that the shareholders are diluted, and that after the purchaser gets in he will be diluted. It cannot mean anything else. Did I read it too fast?

Senator WAGNER. What was the reason for that particular advice? That is what I am trying to get.

Mr. BANE. That advice, Senator, was never given a prospective purchaser until after the passage of the Securities Act of 1933. After the passage of the Securities Act of 1933, with its requirement for disclosure and its sanctions for failure to disclose material matters, this was put into prospectuses so as to warn a man that when he got in there he was subject to a diminution pro rata of the net asset value.

Senator WAGNER. Would not that discourage purchasers?

Mr. BANE. I doubt it, Senator, because I question what this language really means. I will read it again [reading]:

> There results a diminution pro rata of the net asset value of the outstanding shares when the distributor places its order with the trust, which occurs immediately prior to the time when the effectiveness of the then net asset value and public offering price expire.

That means he buys from the trust just before the new price goes into effect. You say that will discourage sale——

Senator WAGNER. I did not say it. I asked you the question.

Mr. BANE. I mean, you asked if it did. I question what that language means to the average type of person to whom these shares are offered. You do not call it dilution, but you read that to the average type of person to whom the share is offered, and the trust can still claim a disclosure, but I question whether many of them really understand the significance of it.

Does that answer your question, sir?

Senator WAGNER. Yes.

Mr. BANE. I would like to offer in evidence a copy of a letter circulated by Massachusetts Distributors, Inc., dated April 4, 1938, addressed "To all members of Massachusetts Investors Trust Selling Group," and I would like to call attention particularly to paragraphs numbered 4 and 5, which I would like to read. These are the instructions of the distributor of these shares to the dealers [reading]:

> 4. Orders received between 3 p. m. of one day and 10 a. m. (Boston time) of the next business day which specify no price are executed at the old or new price, whichever is lower. Orders received prior to 3 p. m. which specify "at market" or the price then in effect, are immediately executed at that price.
>
> 5. Conditional orders will be accepted which specify "at market or better". Such orders will be executed when the next day's price is known and will be executed at the old or new price, whichever is lower. Conditional orders will also be accepted to be executed "on next advance" if those words are used in sending the order to us. Such orders will be executed when a new price of M. I. T. has been computed which shows an advance and such orders will be executed prior to such advance; that is, at the price in effect immediately prior to the advance.

(The complete letter from Massachusetts Distributors, Inc., to all members of Massachusetts Investors Trust Selling Group, dated April 4, 1938, is as follows:)

EXHIBIT A

MASSACHUSETTS DISTRIBUTORS, INC.,
Boston, April 4, 1938.

IMPORTANT NOTICE

To All Members of Massachusetts Investors Trust Selling Group:

The fluctuations of the stock market during recent weeks have caused us to give further thought to the problem of accepting orders for shares of Massachusetts Investors Trust in the event of an extreme rise in prices. The enclosed "Approved practices for transaction of business in shares of Massachusetts Investors Trust," copy of which has already been sent to you, states in the third paragraph that "in the event of extreme fluctuations in security prices we may consider it necessary at some future date to decline to accept orders for shares on the present basis of pricing until an offering price reflecting a new 'liquidating value' may be established."

Rather than leave the question of whether or not we will accept orders on any given day in suspense, we feel that for the convenience of dealers it is desirable to establish a rule of procedure on this question. Therefore, until further notice, in the event the Dow Jones Average of 30 Industrial Stocks should make a net advance for the day of $5 or more, no orders for shares of Massachusetts Investors

Trust will be accepted by us at the old offering price after 4 o'clock p. m. Boston Time on weekdays, or 1 o'clock p. m. on Saturdays.

At present a new offering price reflecting any change in the "liquidating value" is established 1 hour after the close of trading on the New York Stock Exchange each day. This new offering price, however, does not become effective until 10 a. m. Bostom time the following business day. In the event of an advance of $5 or more in the Dow Jones Average of 30 Industrial Stocks, all orders received after the determination of the new price at 4 p. m. Boston time weekdays and 1 p. m. Boston time Saturdays will be held and confirmed when the new or higher price becomes effective at 10 a. m. Boston time on the following business day.

On days of such an extreme fluctuation, orders to be confirmed at the old or lower offering price *must be received* by one of our *branch offices* or by our *office in Boston prior to 1 hour after the close of trading* on the New York Stock Exchange, when the new "liquidating value" is determined.

On days when the Dow Jones Average of 30 Industrial Stocks rises less than $5 there will, of course, be no change in the present method of confirming shares.

MASSACHUSETTS DISTRIBUTORS, INC.

This notice should be attached to and filed with your copy of the selling group agreement on Massachusetts Investors Trust.

APPROVED PRACTICES FOR TRANSACTION OF BUSINESS IN SHARES OF MASSACHUSETTS INVESTORS TRUST

1. Offering price is computed by the custodian bank as soon as an inventory can be taken after the close of trading on the New York Stock Exchange each business day. This offering price becomes effective at 10 a. m. (Boston time) the morning of the next day on which the New York Stock Exchange is open for trading and ordinarily continues until a new offering price, figured in the same manner, becomes effective at 10 a. m. the following business day. These prices are communicated to dealers by us and are published in leading newspapers throughout the country. Offering price is established by computing the asset or "liquidating value" (cash, dividend accruals, and securities owned at closing quotations) and dividing said asset value by 0.9425. In the event of odd fractions the offering price is adjusted to the nearer cent.

2. The bid price is the net asset or "liquidating value" adjusted to the nearer cent. This bid price remains effective until a new inventory is taken after the close of trading on the New York Stock Exchange UNLESS the general market level declines during market hours in which event the bid is lowered accordingly. Note that inasmuch as the offering price which is based on the net asset value ordinarily continues in effect over a 24-hour period, the bid price (net asset value) cannot be increased during market hours when the general market level increases.

3. *Bid and offering prices are both strictly subject to confirmation by us.*—While the terms on which a dealer accepts an order from one of his customers are of course a matter between the dealer and the customer, we feel that members of the selling group, for their own protection, should accept all orders for Massachusetts Investors Trust strictly subject to confirmation. We make this suggestion because in the event of extreme fluctuations in security prices we may consider it necessary at some future date to decline to accept orders for shares on the present basis of pricing until an offering price reflecting a new "liquidating value" may be established.

4. Orders received between 3 p. m. of one day and 10 a. m. (Boston time) of the next business day which specify no price are executed at the old or new price, whichever is lower. Orders received prior to 3 p. m. which specify "at market" or the price then in effect, are immediately executed at that price.

5. Conditional orders will be accepted which specify "at market or better." Such orders will be executed when the next day's price is known and will be executed at the old or new price, whichever is lower. Conditional orders will also be accepted to be executed "on next advance" if those words are used in sending the order to us. Such orders will be be executed when a new price of Massachusetts Investors Trust has been computed which shows an advance and such orders will be executed prior to such advance; that is, at the price in effect immediately prior to the advance.

6. Telegrams to Massachusetts Distributors, Inc., may advisedly be worded as follows: For buying shares, "Confirm one hundred twenty-one M. I. T. nine-

teen thirty-seven (or 'at market')"; for selling shares to us, "Offer one hundred twenty-one M. I. T. nineteen thirty-seven (or 'at market')."

7. Collect telegrams will be accepted by Massachusetts Distributors, Inc., for orders of 10 shares or more (not less) and such orders will be confirmed by prepaid telegram. Dealers are requested not to accept orders for less than 5 shares from new customers.

8. Draft on dealer's bank will ordinarily be sent attached to certificate in street name for 10 shares or more upon dealer's request. Certificates in customer's name will not be sent draft attached, nor will certificates be put in customer's name until full payment has been received by Massachusetts Distributors, Inc.

9. Payment for shares in full, minus dealer's concession is due upon receipt of order, and Massachusetts Distributors, Inc., may in its discretion require such payment in New York or Boston funds. If payment of amount due (or credit on draft) is not received within 5 days of confirmation of order, interest will be charged for the entire period between receipt of order and receipt of payment.

10. Transfer instructions on shares held for dealers by Massachusetts Distributors should be sent in duplicate to Massachusetts Distributors, Inc.; transfer instructions on certificates in the dealer's possession should be sent with certificates directly to the transfer department, State Street Trust Co., 8 Congress Street, Boston. More detailed instructions will be found in our leaflet, Requirements for Issuance and Transfer of Massachusetts Investors Trust.

11. Certificates in customer's name will be obtained with minimum delay by making direct payment to Massachusetts Distributors, Inc., in Boston or New York funds accompanied by transfer instructions.

12. Shipping cost on sales literature will be paid by Massachusetts Distributors, Inc., only when shipment is by ordinary parcel post. If shipped by any other method at dealer's request, such shipping cost will be charged to the dealer.

13. Cost of tax stamps is deducted by us from the amount due when we purchase shares from dealers.

14. The above terms are subject to the provisions of the selling group agreement.

MASSACHUSETTS DISTRIBUTORS, INC.

DECEMBER 1937.

I told you, based on information furnished by these 78 trusts, without check by any agent or representative of the Commission, that approximately 60 trusts on 1 day, Septemper 5, 1939, were diluted to the extent of $1,585,000, and on the 3 days of September 5, 11, and 19 of 1939 were diluted to the extent of $1,750,000. After a conference, Mr. Traylor wrote me on December 28, 1939, in reference to the problem of dilution in which he indicated the steps he and others in the industry were taking did not go far enough to solve this problem.

I should like to read you the letter which is addressed to me, from Mr. Mahlon E. Traylor. It is as follows [reading]:

DEAR MR. BANE: Following our conversation with you in Washington the other day, we proceeded to carry out our plan to change pricing methods for the sale of shares of Massachusetts Investors Trust, to become effective January 2, 1940. In that connection we sent a letter last night to the members of the selling group telling them about the change and attached to it a longer communication discussing the problem in some detail. I though you might be interested to read this letter and have a copy of it for your file. I am also sending a copy of it to Dave Schenker.

It is our considered judgment that this is a constructive move and we expect to keep records to prove to our satisfaction that we are correct in the stand we have taken. I think this change will be responsible for most of the distributors changing their procedure and I have already heard of a number of the distributors who are taking definite steps to stop selling before the new price becomes known in the afternoon which is a step in the right direction but, in our judgment, does not go far enough to solve this problem.

Sincerely yours,

MAHLON E. TRAYLOR.

I would like to introduce the letter that he sent with it, the enclosure with this letter. I have only one comment to make on this. I was somewhat surprised at the type of person to whom this enclosure is addressed, in view of the claim that this is an investment trust. This letter is headed "Important Notice to Sales Managers and Traders." I have been told they did not trade in that trust.

(The notice to Sales Managers and Traders, referred to and submitted by the witness, is as follows:)

MASSACHUSETTS DISTRIBUTORS, INC.,
Boston.

GENERAL DISTRIBUTORS
MASSACHUSETTS INVESTORS TRUST
SUPERVISED SHARES, INC.
BOSTON FUND, INC.

IMPORTANT NOTICE TO SALES MANAGERS AND TRADERS

As of January 2, 1940, the offering price of Massachusetts Investors Trust, determined as of the close of the market each business day, will become effective as of 4 p. m. Boston time on that day (Saturdays, 1 p. m.) and remain effective until 1 p. m. the next business day when a new offering price, based on an adjusted "liquidating value" figured on 12 noon quotations, will become effective. This new offering price will remain effective until 4 p. m.

The "liquidating value" which is the bid price, figured as of the close of the market, will become effective at 4 p. m. Boston time (Saturdays, 1 p. m.) and remain effective until 1 p. m. the next day unless the general market level has declined, in which event the bid will be lowered accordingly. The new adjusted "liquidating value" or bid price, which will become effective at 1 p. m. will remain effective until 4 p. m., though in the event of a decline in the general market level between these hours the bid will be lowered to reflect the decline.

Also as of January 2, 1940, orders for shares of Boston Fund and Supervised Shares will be accepted by us on the basis of the offering price determined as of the close of the market each day only until 4 p. m. of the following business day (Saturdays, 1 p. m.). It is contemplated that as soon as necessary changes can be made in their articles of incorporation, both of these funds will further alter their pricing method to follow that adopted by Massachusetts Investors Trust.

Orders for shares of Massachusetts Investors Trust to be confirmed at the offering price in effect up to 1 p. m. each day must be received by one of our branch offices prior to that hour. Orders for Massachusetts Investors Trust, Supervised Shares, or Boston Fund to be confirmed at the offering price in effect up to 4 p. m. must also be in one of our branches prior to that time.

The reasons for making these important and constructive changes are outlined in detail in the attached statement. Additional copies of the statement and of this announcement will be mailed to you within the next few days and we would appreciate your calling them to the attention of all of the salesmen in your organization. Extra copies may be obtained from any of our branch offices upon request.

New prospectuses on Massachusetts Investors Trust will be mailed to you so as to be in your hands on January 2 and inserts to the Prospectuses of Boston Fund and Supervised Shares will be sent promptly to members of these selling groups. Amendments to the various selling-group contracts, covering these changes, will be forwarded to you the early part of next week.

MASSACHUSETTS DISTRIBUTORS, INC.

DECEMBER 27, 1939.

MASSACHUSETTS DISTRIBUTORS, INC.,
Boston.

GENERAL DISTRIBUTORS
MASSACHUSETTS INVESTORS TRUST
SUPERVISED SHARES, INC.
BOSTON FUND, INC.

STATEMENT WITH RESPECT TO CHANGE IN PRICING METHOD

The attached announcement outlines what we believe to be a thoroughly constructive change in the pricing of shares in open-end investment funds. We

are convinced this new method is not only practical but is equitable from the viewpoint of both shareholders and prospective shareholders alike.

There has been considerable discussion and some publicity recently regarding the present basis for distributing shares of open-end investment funds which have revealed a wide divergence of opinion as to its merits and demerits. Also, because the problem is a complicated one, there appears to be a general lack of understanding and appreciation of the practical difficulties involved in making any change from the present system.

Accordingly, we feel it advisable for us to review our reasons for making the change outlined. In addition, we would like to discuss breifly several other suggestions for changed procedure, discussed by the industry, which we feel are impractical and unnecessary.

HISTORY OF PRICING PRACTICE

Although the subject of pricing has only recently come in for rather widespread discussion, for many years it has received the careful and serious consideration of the leading distributors of shares of open-end investment funds and the system now in general use was evolved only after long, practical experience by the industry.

In the early days of the operations of some of the older open-end funds when fluctuations in the market were not as severe as they have been recently, prices were changed less often than once each day. However, as the funds developed, inventories were taken and prices established more often until the pricing basis now in general use throughout the industry was devised. The offering price was carried over for 24 hours (usually from 10 a. m. of the day following the determination of the price at the close of the exchange until 10 a. m. of the following day) so that all dealers from coast to coast, in spite of the time differential, could offer shares for a full business day on an equal basis.

Telegraphing price changes to a large group of dealers is an expensive process and thus it was arranged that the price figures at the close of the market each day would not become effective until 10 a. m. the following day. Thus new quotations could be distributed by means of postcards which were delivered in most dealer shops the following morning at approximately the time the new price became effective. By an large this method of pricing was considered sound and adequately solved the problems which existed.

Recently, however, the market has shown a tendency toward more violent fluctuations and as a result the 24-hour pricing basis has created a problem on occasions, particularly for some of the specialty and smaller funds whose structures and purposes vary somewhat from our original conception of the cross-section, Boston-type fund. Accordingly, a number of distributors, including ourselves, have felt it desirable to work out a revision of the pricing system which, from the standpoint of the investment fund industry, would better meet the problems presented by our present-day markets.

We would like to reiterate here the view we expressed in our statement last week with regard to Securities and Exchange Commission news releases—that it is our carefully considered judgment that the so-called "dilution" problem has been a relatively negligible factor insofar as the funds under our sponsorship are concerned. In this connection, we stated as follows:

"For example, for the year 1936 on the largest volume of sales in the history of Massachusetts Investors Trust, the so-called 'dilution' amounted to less than one-fifth of 1 percent on the outstanding shares, and for the year 1939 during which the trust experienced the largest single day's volume of sales on one of the most extreme price rises in its history, the so-called 'dilution' is estimated for the full year at only about one-fourth of 1 percent on the outstanding shares. Even this negligible result is largely theoretical in that the indicated amount of 'dilution' represents the difference between what the trust actually received in the sale of its shares and what it might have received had all the shares been sold at the higher of the two known prices each day. Also this result fails to take into account the price level at which the money received was invested. In recent weeks, for example, investment funds have had an opportunity to invest money received from the sale of shares during the September stock market rise at lower prices than those prevailing when the shares were sold and thus not only offset any theoretical 'dilution' but gain a positive advantage as a result of having sold the additional shares. This is by no means an exceptional situation as a review of the pattern of stock market price movements in recent years will quickly reveal."

RESULTS OF NEW PRICING METHOD

In working out a changed pricing procedure we have, during the last few months, carefully considered a number of suggestions proposed by dealers and others in the industry. However, in our opinion, the change we are making is the only one so far proposed which sufficiently solves the problems presented and yet maintains a firm offering price so that dealers may continue to operate on a practical basis.

The change we are adopting will completely eliminate the "two-pricing system" as it has been termed. The figuring of a new offering price during market hours once each day will, it is our honest conviction, sufficiently solve the so-called problem of "dilution" so that it will be reduced to such a nominal amount that, for all practical purposes, it can be completely ignored.

It is generally believed that by those of us who have carefully studied the problem that the new method should result in orders being placed by dealers and salesmen on a more regular basis as they are received and thus will spread out the business so that orders will not be accumulated and held to be executed after a known market rise, as has occasionally been the practice in the past. This in itself, we are convinced, is highly constructive.

A new bid price will become effective each day at 1 p. m., based on 12 noon prices. Thus, on days when the market is up, shareholders desiring to liquidate their shares will not have to wait until the close of the market in order to obtain the advantage of higher prices.

OTHER METHODS PROPOSED

Redetermination of price for each sale.—Probably the only method of issuing and selling new shares which could not be debated from one point of view or the other, would be to establish a new offering price each time an order for shares is received. In our opinion, however, there is no necessity whatsoever for any such theoretical mathematical accuracy and, in addition, on days of substantial business such redetermination of prices would be physically impossible. For example, on one day recently we had in excess of 800 separate sales transactions and on other days we have had close to this number.

On days when the general market level has declined, it has been physically possible to redetermine bid prices when shares are offered for redemption, but the total number of these transcations has been comparatively small.

Redetermination of price each hour while exchange is open.—For all practical purposes, we believe that changing prices twice each day will be as effective in solving problems that exist as more frequent changes. Further, the expense of more than two changes each day would not be offset by any theoretical advantage which might be gained.

Constant changes of price during the course of each day would, we feel certain, engender in the minds of shareholders, prospective shareholders, and salesmen alike an interest in hour-to-hour market movements which is contrary to the basic principle of the investment fund as a long-term investment medium.

Discontinuance of sales after unusual rise in market.—This suggestion has merit in that the major problem in connection with the present system of pricing comes only on those days when there is a substantial rise in the market. However, we believe that it does not go as far in solving the problem as a repricing of shares every day based on noon quotations, regardless of whether the rise in the market is nominal or larger than usual. It seems to us, too, that salesmen will prefer the definiteness of a price change at a known hour to the indefiniteness of the discontinuance of sales after an unusual rise in the market.

Sale of shares only when stock exchange is closed.—We have given very serious consideration to the suggestion that no shares be sold while the New York Stock Exchange is open. This method of operation is familiar to us for, when we first publicly offered shares of Boston Fund, we attempted, as an experiment and as a matter of practical protection to a small fund, to issue shares only on this basis.

Our practical experience with this method has satisfied us that it is not, under all circumstances, equitable to the new shareholders entering the fund. Also, as a result of our study, we are convinced that this method, which would completely eliminate an offering price during normal business hours, is not a reasonable or satisfactory solution to the question of pricing. It is not only contrary to general practice in the investment business but it is also contrary to sales methods followed in every other line of business endeavor.

We believe that such a pricing method would work a serious and unwarranted hardship on the dealers offering shares and would drastically reduce the total volume of business done.

CONCLUSION

We would like to emphasize our conviction that the change in pricing method which will be adopted by Massachusetts Investors Trust on January 2 and which we anticipate will be adopted by Supervised Shares and Boston Fund shortly thereafter is the best solution to the problem resulting from recent market conditions that we have so far been able to devise.

We believe it to be equitable to shareholders already in the funds and to new shareholders entering the funds. In addition, we are convinced that it is sufficiently practical from an operating viewpoint so that the activities of dealers and salesmen interested in placing shares with their customers will not be impaired.

MASSACHUSETTS DISTRIBUTORS, INC.

BOSTON, MASS., *December 27, 1939.*

Most open-end investment trusts deliberately, and not unintentionally, employ a method of pricing new shares which they know dilute the interests of their existing shareholders for the purpose of increasing sales and management fees, thus increasing the remuneration of the distributors of such shares and the managements of such trusts.

I have indicated before and I reiterate that the managements of many investment trusts have indicated to me personally and to other representatives of the Commission that they deplored the effects of the two-price system and would welcome any regulation uniformly applicable to all trusts that would tend to stamp out such abuses.

I should like to read two letters voluntarily written to the Commission illustrating this sentiment. We, at approximately the same time, received similar letters from at least nine other companies.

If you want me to, I will give you the name and signature, but I should prefer not to. This first letter is dated October 20, 1939, addressed to the Securities and Exchange Commission, my attention [reading]:

There is returned herewith, in duplicate, the questionnaire addressed to this company. We appreciate your courtesy in permitting us to forward the material at this time rather than on October 16; the work involved in assembling the information was substantial. We will, of course, be glad to furnish any additional material you may require.

We should like to take this opportunity to make certain observations regarding some of the problems of investing companies such as ourselves—observations based not only upon our studies of the material furnished in the questionnaire, but also upon other studies we have conducted over a long period of time. The general scope of the questionnaire raises questions that are by no means new to us since these and other problems have long been a matter of research on our part in a continuing effort to eliminate, insofar as practicable, all possible, as well as all actual, abuses, and to make certain that our procedure is fully and frankly set forth in our registration statements and prospectuses.

Since many of the practices, in this as in other businesses, are often influenced by competitive considerations, or studies necessarily have included examination of the practices of similar companies. Wherever it has been feasible to do so we have been quick to make changes which we felt would improve our methods and policies. The following indicate some of the steps that we have taken along these lines:

First. Prior to January 1938, ——— ——— (the national distributor for this company) acted as principal in the sale of our securities. So to act left the door open to possible profits (and losses) to be derived by the sponsor from positions taken in trust shares. It also made it possible for the sponsor to hold back or to anticipate orders for shares and to make a profit by so doing. The fact that this was possible indicated the desirability of the sponsor acting not as principal, but as sales agent in the distribution of the securities of this company—a relationship which was put into effect in January of 1938 and which still endures.

Even under the selling agency arrangement it was still possible for the sponsor to repurchase shares for its own account. While it was recognized that this, too, was undesirable, it was not possible to make the change until the charter of this company had been amended to permit it to repurchase its own shares during

market hours. This amendment was made in August of 1939 and, as it now stands, the sponsor is permitted to act only as agent for the company in all transactions relating to its securities, both on the sale and repurchase side.

This agency relationship makes it completely impossible for the sponsor to realize any profit, riskless or otherwise, as a result of a long or short position in the securities of this company. We firmly believe that this procedure is the proper one and, whether sponsors generally profit as a result of positions or not, it should be made uniform throughout the industry.

Second. Another instance of steps taken to eliminate possible abuses is connected with the possibility of an officer or director of this company, of the sponsor or of other associated company, personally to take a position in the securities of the company purely for speculative reasons. No instance of such a position having been taken has ever occurred, yet it was felt desirable to prohibit such individuals from purchasing shares of this company except on a purely investment basis. This policy was put into effect some time ago and makes it impossible for any "insider" to derive a speculative profit, riskless or otherwise, from a long or short position in the securities of this company. This, too, we feel is eminently proper and, whether such "insiders" generally profit as a result of such positions or not, should be made uniform throughout the business.

Third. For some time this company has been concerned over the possibility of dealers or others taking advantage of the method used in determining the price upon which its shares are to be sold. The price calculated as of a given day is effective throughout the entire following day which, as stated in the prospectus, results, in a rising market, in shares being sold at a price to net the company less than the asset value at the time of sale. This would make it possible, on a day of a sharp rise, for dealers to profit as a result of being able to place orders at a price based upon the preceding market close. To obviate this there has long been, in a standard Distributor's agreement, a provision which reads as follows:

"Your attention is directed to the following sentence in the prospectus referred to: 'It will be the practice of the selling agent to act only as agent, and not to profit nor to permit, knowingly, either Subselling Agents or distributors to profit by a change in the net asset value from that used in determining the price in their respective orders.'

"Your acceptance of this agreement will be deemed a commitment on your part that your practice will conform to the foregoing."

Every effort has been made to see to it that the distributors live up to this provision of their agreement and in any case where it has been found that a distributor has failed to do so, that distributor has been removed from the selling group. We believe that each investing company should be alert vigorously to protect itself against dealers who might be tempted to take advantage of circumstances to their own undeserved profit.

Fourth. One of the things which has given us considerable concern for some time has been the fact that practically all investing companies permit the offering price calculated as of the close of the market on a given day to remain in effect long after the new price has been calculated. It is obviously impracticable to calculate a new price any time other than at the close of the stock market. Consequently, it has been necessary that the offering price remain effective at least throughout the trading hours of the next following day. While one or two companies close off the price before the new price is calculated, others, however, carry the old price through to 5:30, others to 9 o'clock, others (including ourselves) to 12 midnight, and still others carry it until 10 o'clock the following morning. This means that there are two announced offering prices for a considerable period of time, with the lower of the two always being the price at which sales are made. It has long seemed to us that there was little or no logic backing this procedure and, while it is completely revealed in the various prospectuses, it would be distinctly for the good of the business if this so-called two price system were eliminated. Such elimination, however, is something which, for obvious competitive reasons, must be done by all important companies or by none. Crusaders along these lines have found that their competitors who had not changed soon had most of their business, and that they were left with only the satisfaction of believing that the procedure had been sound. In our opinion, elimination of the "two-price system" is highly desirable and is something which should be made effective for all investment trusts. We state, unequivocally, that as soon as we are able to obtain some assurance from our principal competitors that they will do likewise, we will forthwith make the necessary change in our procedure, and, of course, will amend our registration statement and prospectus accordingly.

Fifth. Because of the practical necessity of selling shares today at a price computed upon yesterday's closing prices, most investing companies have found that

the great bulk of their business is received on days of rising markets. It follows, too, that the larger the rise, the greater the business. We have often considered the desirability of restricting the number of shares sold on days when the market rise is so sharp and the corresponding increase in the asset value so great as to make additional sales at the old price undesirable. While we have not as yet reached a definite conclusion on this matter, it may well be that some steps should be taken along these lines. We have been considering the possibility of announcing to dealers that on any day when the hourly report on the movement of Dow-Jones Industrial Averages, as officially announced on the news ticker, shows an increase of 3 percent or more over the previous close, sales will be discontinued at the end of the next hour. For example, if the hourly industrial averages at 11 o'clock show an increase of 3 percent or more, sales on that day will be discontinued at 12 o'clock until the new price, computed as at the close of the market, has been determined. Such action would undoubtedly decrease substantially the volume of business done when the rise can be deemed to be too great to warrant further sales and, if made to operate jointly with the close-off of sales at the old price, as discussed above, would substantially eliminate possibilities of abuse. We feel that if the investing companies generally adopted a practice such as this, on some uniform basis, the movement would have our complete sympathy and cooperation.

As a practical matter, we believe it should be borne in mind that days such as September 5 seldom occur. It is our opinion that September 5 will prove to have been unique in the history of the Stock Exchange. For this reason we feel that the happenings of September 5 should not be taken as typical and that too many conclusions should not be drawn from the particular and special problems which arose on that day.

Please be assured of our continued cooperation at all times.

Very truly yours,

I would like to read another and shorter letter, along the same lines, but more concise. This letter is dated November 21, 1939, and is addressed to me (reading):

In connection with the recent questionnaire sent to investment trusts by your division, I should like to submit a copy of some recommendations which I made to the Investment Trust Study last year, which cover specifically on page 4 the points involved.

My fundamental premise is that the investment trust industry must either clean up or "be washed up." For its own sake—wholly irrespective of public policy—these abuses in the distribution of investment trust shares should be fully eliminated and I have no sympathy with any mere gestures, which would allow the abuses in the main to continue and not fundamentally correct the problem. What I have in mind is any proposal to adjust the price if the appreciation on a subsequent day is more than say 2, 3, or 4 percent, or to advance the time for a very few hours in making the daily price change, but at the same time leaving the one-day lag substantially in effect.

The one clearcut, effective way to eliminate the abuses growing out of the price-lag is to eliminate the price-lag itself. If all sales on any given day were based on that day's (rather than the preceding day's) asset value, the problem would be cured. After all, most redemptions are on the current day's asset value and there is every advantage in having sales on the same asset value. The objection to not having a firm price prior to 3 o'clock on any day does not impress me, particularly in view of the fact that under the present system practically no orders are received prior to the market's close, because of the desire of the dealer to compare the close of the current day's market with the previous close before deciding to place his order. As for the Far West, the Pacific Coast under such a system would have a firm price from shortly after 11 a. m. in the summer and shortly after 12 noon in the winter, and as far as having a firm price is concerned would be better off than the East.

Unfortunately, the competitive situation in the open-end trust industry is such that increased competition does not work for the benefit of the investment trust purchaser, but rather to his detriment. This appears to be attributable to the fact that the industry has not yet reached the point where the competition is for "consumer appeal" but rather for "dealer appeal." Consequently, the Securities and Exchange Commission without any legislation whatsoever could do a very effective thing if it would publish just the simplest kind of handbook—in primer style—for the investing public, which would point out the essential factors to look for and call attention to abuses such as occur in this price lag, and to

the switching device so frequently used by dealers to generate business. It is obvious that some pressure will be required to correct the abuses created by competition and if it is to go to the point of legislation it could be very effectively handled by including in the mutual trust section of the Revenue Act a provision that to qualify the investment trust must never sell its shares at a price less than its current asset value, and, for that matter, a provision for limitation of the selling load.

When this is accomplished, not in some half-hearted measure, but fully and completely, the investing public and the investment trust industry as well will be much better off. The investment trust should be an institution—in a sense the equity counterpart of a building and loan association—for the professional management of the public's investment capital. Many of the abuses have come from making the investment trust a stock-jobbing scheme and hence the emphasis upon high-pressure "peddling" of the shares. The approach to the prospective investor should not be one of offering shares at a price less than their current worth (because of a sharp rise in the market and the price lag) but rather the approach should be on a professional basis; namely, that the investor is being asked to place his investment funds—$5,000 or whatever they may be—under the management of the investment trust. From this professional point of view the question of whether a firm price accurate to the cent is available to the salesman at any given moment is of no consequence. Moreover the implication of this professional point of view as distinguished from the stock "peddling" point of view is very far reaching and constructive so far as bringing into clear relief the philosophy upon which the investment trust busiuess should be operated by the management and viewed by the investing public.

These recommendations are presented by us directly rather than through a group in order that we may be in a position to make our recommendations clearly and candidly reflect our own beliefs, without the compromise and emasculation which generally occurs in the formulation of group opinion.

If we may be of any service in working out this problem please do not hesitate to call upon us.

I think I have made it clear that these are letters from the industry, not from outsiders.

Senator WAGNER. They recognize that that is a problem.

Mr. BANE. Apparently, very clearly so.

Now I should like to read other letters, and I think it will take me probably about 15 or 20 minutes more. This letter is along the same line——

Senator WAGNER. Are they letters of the same kind?

Mr. BANE. I have here a letter from the vice president of the Massachusetts Distributors dealing with the problem.

Senator WAGNER. I think you ought to read it. Some of the others you might put into the record if they are along the same line.

Mr. BANE. All right, sir. This letter is addressed to the Securities and Exchange Commission, attention of Mr. Lund, our expert. It is dated February 25, 1940, and reads as follows [reading]:

Last week Mr. Bane suggested to Mr. Traylor that it would be helpful if we would send down to you some suggestions with regard to rules and regulations which the Securities and Exchange Commission might draw up to govern the pricing and sale of shares of open-end investment funds. There are so many angles to the problem, we are very hopeful no attempt will be made to incorporate a specific pricing procedure in the pending legislation, for we feel that the only practical way to handle the situation is through regulation in cooperation with the industry. If no procedure is written into the law, there will be sufficient flexibility to permit a complete examination of the practical aspects of the problem and the working out of a solution for the various types of funds on some reasonable and equitable basis.

Even if no legislation is passed this session, we are anxious to see some solution to the pricing problem worked out in the near future. We believe that a major portion of the industry can agree on a practical plan. At the moment, we understand a number of funds have deferred action on any change in practice until you have completed your study so that if something practical is agreed on, no further charter changes will be necessary.

It seems to us that there are two separate points to be considered in working out a solution to the problem: (1) The setting up of safeguards through the funds and the distributors to prevent any abuse, such as "riskless trading," of whatever pricing system is adopted as standard practice; and (2) the effective reduction of so-called "dilution" to a practical minimum.

* * * * * * *

Regarding the setting up of safeguards against abuse, we would like to suggest that consideration be given to the following:

(1) No underwriter should be allowed to sell shares to a dealer unless the dealer has signed a distributing contract with the underwriter, establishing certain standards of fair practice.

(2) The dealer contract should provide for a placement period of sufficient duration to prevent "in and out" trading on any basis, whether riskless or not. This could be handled by the withholding of dealer discounts if shares are tendered for redemption within the placement period. Also, if no technical or State "blue sky" problems arise, the funds themselves might prohibit the redemption of shares issued until after the expiration of the placement period.

A placement of 7 to 10 days might well be sufficient to solve the problem and should not handicap any underwriter or dealer honestly attempting to distribute shares on a sound basis.

(3) Any dealer or street trader not bound by contract to the underwriter should be required to identify certificates tendered for redemption. This would effectively eliminate short selling against the funds.

(4) The underwriter should act as agent and not as principal in the repurchase of shares. In this connection it would probably be advisable to provide allowance for compensating the agent for out-of-pocket expenses in handling the repurchase of shares. Most open-end companies reserve the right to charge up to 1 percent to cover such expenses although, as a matter of policy, few of them have exercised this privilege.

(5) If the Securities and Exchange Commission could solve the problem of the dealer becoming involved in an underwriting liability, an underwriter should act as agent in the sale of shares as well as on repurchases. However, if the problem of dealer underwriting liability cannot be answered satisfactorily, an underwriter acting as principal should be prohibited from taking a long position by purchasing from the fund more shares than are required to fill orders received.

(6) In order to prevent "in and out" trading on the part of individuals in the management or sponsor organizations, a reasonably long placement period for shares sold to such individuals would be desirable—perhaps 45 or 60 days. The recent Ohio regulations (Q. 3) provide for the payment of the full retail price by "insiders" when purchasing shares. While we believe there is some merit in this plan insofar as minimizing trading activities is concerned, we do not believe it will be as effective in forcing purchase only for investment as a long placement period. Furthermore, forcing "insiders" to pay sales costs when no such costs are involved, does not strike us as sound business practice.

(7) In repurchasing shares during market hours, the bid price should be lowered to reflect any decline. Because there is no psychological necessity for a firm price when shares are tendered for repurchase and because the total number of repurchases is usually substantially smaller than the number of sales, it has been found practical to handle repurchases on this basis, even in the larger operations. This eliminates the possibility of profit as a result of "riskless" short selling.

* * * * * * *

With regard to the reduction of so-called "dilution" to a practical minimum, we believe that no satisfactory solution can be found to this problem until it is generally recognized that what may be a satisfactory and practical solution for one type of open-end company may not be a satisfactory solution for other types of open-end companies.

More than 85 percent of the total amount of assets of the open-end companies is represented by the type of company such as Massachusetts Investors Trust. These companies were created on the basis of their being conservative investment mediums and their portfolios represent a broad cross-section of selective diversification under continuous supervision. They are sold as a permanent type of investment and not as a medium for trading in and out for speculative profits.

The balance of the open-end companies, by and large, were designed to serve an entirely different purpose, and are represented to the public on an entirely different basis. Some of these companies are highly speculative, while the others possess varying degrees of speculative character. In these companies, the

percentage fluctuations in asset value, both up and down, exceed by a large margin the fluctuations in the asset value of the more conservative type of fund. As a result, the problem of "dilution" is far more acute. We are convinced, in our own minds, that a general formula for pricing cannot be worked out which will solve the problem for all types of companies alike.

We do not mean to imply that these more or less speculative funds do not occupy a perfectly legitimate place in the investment business, if properly conducted. We merely contend that they are created for a different purpose, sold on a different basis which is noncompetitive to our type of fund, and that their dilution problem cannot be solved in the same way that the problem can be solved for 85 percent of the open-end industry.

As you know, on January 1, 1940, Massachusetts Investors Trust adopted a system of pricing shares twice each day. This appears to be working out on an eminently satisfactory basis and we believe that this system, or some refinement of it, will for all reasonable purposes solve the problem for the funds similar in character to Massachusetts Investors Trust. It eliminates the accumulation of orders to be executed prior to the next advance, and it assures an adjustment of offering price upwards during market hours when the general market level has advanced so that the price received for shares more closely approximates their theoretical "liquidating" value at time of sale.

Perhaps this is not the final solution to the problem, even for the cross section open-end funds, but no one can deny that it is a constructive step forward on a basis which is practical enough to allow business to be done. We are convinced that it would be wise for the industry at this time to adopt, with the cooperation of the Securities and Exchange Commission, the two-price-a-day system and to incorporate rules for fair practice such as I outlined above. Results could be carefully checked and problems corrected as they develop. Further changes could later be made if experience indicates that they are necessary.

I expect to be in Washington on Tuesday the 27th and would like very much to have an opportunity to go over this matter with you.

It is signed by the vice president of Massachusetts Distributors.

If one were to engage for a fee an individual purportedly skilled in dealing in horses or automobiles to use one's money to buy and sell horses or automobiles in order to earn a return on the money used, and if this individual were to offer to buy all horses or automobiles at $100 and at the same time sell all horses or automobiles at $93, somebody would probably think of putting him into an asylum.

This method of doing business sounds fantastic and yet on September 5, 1939, some of these trusts were bidding higher prices for their shares than the public offering price at which the shares were being sold at the same time. In one instance one trust was selling shares at $17.78 and at the same time this same trust was offering to redeem and did redeem shares at $19.21.

Senator WAGNER. How did that come about?

Mr. BANE. The price at which they were selling during the day was based upon the prior day's close. The price at which they were redeeming shares was based upon that day's liquidating value of the underlying portfolio. The portfolio had increased in value during the time they were continuing to sell on the price of the prior day's close, at $17.78, so that as a share was turned in for liquidating they were giving $19.21 for it.

This is another graphic illustration of the effects, potential and actual, of the two-price system and indicates the deliberate underpricing of the shares by the trust.

One witness from the industry before you claimed that the two known and established prices were of little or no importance as a sales argument or as in inducement for sales, yet one other witness from the same distributing organization attempted to justify the two-price system by claiming that a firm and established price is not only

necessary in order to market the securities but is essential to the continued operation of the business.

I have had many conversations and conferences with representatives of this industry, but it was in the testimony here that I heard for the first time that two known and established prices were of no importance in making sales, in fact, were not a principal inducement in effecting sales. Certainly, from the statements contained in the letters I read, representing the views of many in the industry, and from conversations I have had, it is clear that no trust of this type has seriously attempted to abandon this practice cognizant of its dilutive effect, because they realize that they could not sell in competition with the other trusts employing the two-price system. If it is of no sales importance whatever, then practically every investment trust of this type is purposely diluting existing security holders out of mere whim and caprice and not for the purpose of meeting competition. It does not seem logical that a salesman, understanding how the shares are priced and that two prices are known from about 3 or 4 o'clock in the afternoon until 10 o'clock the next morning, will not use such a fact to induce sales. It is generally admitted by the industry that from at least 70 to 90 percent of all sales are made on a rising market, when dilution occurs. Obviously, there is a definite relationship between volume of sales and the two-price system.

The story given you by witnesses from the industry of how sales are effected was most unrealistic. To compare the pricing and sales methods and the effects thereof of these trusts with the sale of Treasury bonds is illustrative of the sales ideas and arguments of many of these investment trust salesmen. The statement made by Mr. Traylor respecting dilution arising from the sale of Government bonds is incredible. I have never seen the occasion when the Government was offering bonds for a period of 19 hours at two different prices, affording a purchaser the opportunity to purchase at the lower of the two prices.

As an illustration of the methods pursued in selling trust shares, I should like to read a paragraph from a letter from one of these companies [reading]:

> One of the primary evils, in my mind, in investment trust selling has been the price situation. Many sponsors have not gone out and sold investment trusts on their merit or on the sales appeal of diversification, but have gone out on a price appeal situation, offering someone $5 in value for $4.50. To my mind this is basically unsound and there is no reason why the same amount of business could not be obtained by using sound sales methods. It is going to be essential, however, that all trusts standardize their pricing * * * so that the purchaser cannot go across the street and buy "prices" from some other dealer. * * *

Senator WAGNER. Our committee reported yesterday a bill to amend the Trading with the Enemy Act of 1917, as amended, and it is very important. It is to come up just as soon as we finish a bill now before the Senate for consideration, which will be in about half an hour, I think. I must be there to take that bill up.

Mr. BANE. I can finish in about 5 minutes, Senator.

Senator WAGNER. Very well.

Mr. Griswold, of Massachusetts Investors Trust, in reference to the requirement that sales literature other than the official prospectus be filed with the Commission, characterizes the requirement in the bill as "bureaucracy for its own sake." He indicates that there is no necessity for it, particularly with reference to his trusts, Massachu-

setts Investors Trust, Boston Fund, and Supervised Shares. It is interesting to note that Dr. Sprague, who testified before you as a trustee or adviser of Massachusetts Investors Trust, when asked in September 1936 what he thought about certain sales literature used by investment trusts, said—in speaking of such literature—that it "is apt to contain things which may be apt to make one's hair curl a little bit."

Mr. Bunker, of the Lehman Corporation, who testified in these hearings, said in his testimony:

In the first place it is a mistake and a very serious mistake to confuse in the slightest degree the conception of investment companies with the conception of savings banks. If a man puts his savings in a savings bank he has money in the bank, money which, subject to minor restrictions, he can withdraw at any time and which he can withdraw in the same amount which he has put in, plus interest, no more and no less. That is his contract.

But if a man invests in the stock of an investment company and particularly if he invests in the common stock of an investment company, he is putting his money at the risk of the market and when he realizes on his investment he will realize the then market value of his investment, which he hopes may be more, but which may very well be less than he has paid in, by the terms of his contract.

(At this point Senator Wagner, chairman of the subcommittee, left the hearing room.)

Senator Hughes (presiding). Please continue, Mr. Bane.

Mr. Bane. I continue the quotation from the testimony of Mr. Bunker:

If any salesmen of investment company securities have attempted to confuse investment companies with savings banks they have been guilty of gross fraud and they should be dealt with accordingly. If additional legislation is necessary for such purpose let such additional legislation be passed. But do not allow yourself to be misled, because of fraudulent statements of this nature that have been repeated to you, into the idea that investment companies resemble savings banks.

Now let me read to you an extract from an illustrated booklet entitled "Massachusetts Investors Trust, History and General Information," put out by Massachusetts Distributors, Inc., in 1935, used as supplemental selling literature and, which so far as we know, is still used:

Massachusetts Investors Trust is a mutual trust. It is operated on a basis similar to a mutual savings bank. Like a savings bank it depends for its future welfare and continued success upon public confidence.

Mr. Traylor said to you that it was very easy to confuse the word "dilute" with the word "loot," and he wanted to make it clear that the pricing system used by the open-end investment trusts involved no element of looting. In my previous remarks I did not refer to or use the word "loot," but so far as the net effect from the standpoint of the shareholder is concerned there would appear to be little reason for drawing a distinction, and there is little practical difference between looting and the operations of this system.

What I have said does not relate to past practices only. These practices employed by the majority of these trusts are continuing, everyday practices. It is true that some of these trusts recently made some pricing changes, not in method, but only in the length of time two known and established prices exist. But dilution has not been stoppted. It still goes on day after day.

Considering these matters in their true light and the manner in which they have been presented to you by members of the industry,

you get some indication of the difficulties encountered by the S. E. C. in getting a fair, adequate, and accurate disclosure of these practices under the Securities Act of 1933.

I believe thoroughly in the principle of the Securities Act of 1933. There is nothing paternalistic in it. The principle of adequate and accurate disclosure is, in the usual case and with reference to the ordinary situation, enough; but there are some situations where admitted abuses and the effects of such abuses, even though explained, would be little understood or appreciated by the types of persons to whom the securities are offered, or the abuses are hidden in the nature of the set-up or organization. In such situations, further steps are necessary to protect the investors.

I concur wholly in the opinion of Mr. Mathews expressed before this committee, which was also quoted favorably by Mr. Adler:

> I would be very much opposed to any program which, under the mask of regulation, sought to do more than to impose those restraints upon management which are really necessary for the protection of investors, but any course which does not impress its restraints may be very misleading to those whom it professes to protect.

and I don't mean by this to endorse every section in the bill as drafted. I have not thought through each section of the present bill.

It is with reference to these practices I have been talking about, and not with reference to the bill as a whole, which I have not completely analyzed.

I shall be very glad to answer any questions you may have.

Senator HUGHES. Thank you. I believe that is all.

Mr. HEALY. Senator, will you be kind enough to call Mr. Francis Greene as a witness?

Senator HUGHES. All right; Mr. Greene, will you please take the stand?

STATEMENT OF FRANCIS GREENE, ASSISTANT DIRECTOR, TRADING AND EXCHANGE DIVISION, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. GREENE. Senator, my name is Francis Greene. I am an Assistant Director of the Trading and Exchange Division of the Securities and Exchange Commission. I wrote the letter, part of which Mr. Eberstadt read during his testimony on last Thursday, April 18. Because of the impression of the S. E. C. staff, which Mr. Eberstadt may have created by his references to that letter, I should like, if I may, to explain the background of the letter and to explain why it was written.

Pegging, fixing, and stabilizing of security prices is a type of market manipulation commonly used by underwriters to support market prices and thus to speed up their distribution of securities to the public. Under the Securities Exchange Act of 1934, the Commission is charged with the duty of regulating this type of market operation. Earlier congressional investigations, as well as the experience of the Commission itself, since 1934, have shown the grave abuses which may be made of this type of market operation. The Commission, in order to achieve the objectives, first, of regulating stabilizing—at least to the extent of scrutiny—and, second, of getting definite information on all of the angles of the problem, adopted a rule which requires under-

writers who want to stabilize in order to facilitate security distribution to file current reports of just what they do in their operations.

At this point I should like to explain that the Commission administers several statutes, and that the rules which it has promulgated under those statutes are prefixed by a letter indicative of the statute under which they are put out. Thus, rules under the Holding Company Act are prefixed by the letter "u", for "public utilities"; rules under the Trust Indenture Act carry the letter "t"; and rules under the Exchange Act carry the letter "x", for "exchange". The numerals in the rules show the section under the statute pursuant to which it was adopted; and the last digit in the name of the rule shows whether it is the first or the second or the third rule under that section of the act, and so on; so that the rule, right on its face, tells anybody who is interested just exactly what it deals with and under what provisions of the legislation it was promulgated.

Eberstadt & Co. was the manager of the stabilizing syndicate on a public offering of some $900,000 of Hydraulic Press Manufacturing Co. stock, made last December. Eberstadt & Co. violated the reporting rule, by its failure to file any reports showing the transactions of the underwriting and stabilizing syndicate, as such, on the day of the offering.

On March 23, 1940, this firm wrote us a letter about its reports, which indicated that it was thoroughly confused as to how to report its operations. Accordingly, I wrote the letter to which Mr. Eberstadt has referred during his testimony.

First, I should like to point out that my letter was addressed to the attention of Mr. Edward B. Conway, a lawyer whom I know personally, who was formerly on the staff of the General Counsel of this Commission. I knew that he was familiar both with the details of Federal securities regulation and with the mechanics of security stabilizing and distribution. Consequently, I wrote to Mr. Conway as a technician, knowing that he was a technician, and I used technical language, in an effort to help this firm by a careful and comprehensive explanation of just how the reports should have been made out. My letter was not, nor was it intended to be, a layman's letter. Subsequent events indicate that Mr. Conway must have fully understood the suggestions which were offered in my letter.

My letter of the 27th went into extensive detail, for several reasons. First, I wanted to do a thorough job in clearing up the firm's wholesale misunderstandings. Secondly, Eberstadt & Co. was the syndicate manager to whom the other underwriters usually turn for advice and suggestions in matters of this kind. I hoped to be able to prevent its making similar errors on the future reports that I knew it would have to file covering similar future operations of which it would be the syndicate manager. Thirdly, the reports first filed by this firm were so incomplete and so erroneous that if Eberstadt & Co. was to get any useful advice as to how to comply with the requirements, I had to discuss varying combinations of assumed but, nevertheless, possible circumstances which may have affected the way in which it would have compiled these items of information.

I must, of course, confess that my letter, as it was read aloud, sounded—as it was—both technical and complicated. I have explained why it was written in technical terms. On the other hand, its complexity resulted from the fact that modern syndicated security

distributions, and their accompanying stabilizing operations, are themselves highly complicated processes. It is hard to write a simple letter about a complicated matter.

Faced with incomplete and, indeed, even misleading reports of the market operations, such as these, there were three courses open to the Commission. We could have written a short and simple letter calling for the prompt filing of correct reports. This would have been easy for everybody concerned except Eberstadt & Co., which would have had to go to its lawyers; or, second, we could have instituted court proceedings based upon the firm's inadequate and inaccurate reports.

However, we had a third alternative. In an effort to help this firm, I sat down and wrote Eberstadt & Co. as careful and as thorough an explanation as I could of just what the rules required and of just how its corrected reports should be made out. Of course, such a letter requires meticulously careful drafting, since the legal rights and legal liabilities not only of this but of other security houses are dependent upon its accuracy.

This kind of explanation, given in conference as well as by letter, has proved a real help both to the underwriting industry and to the Commission, in the past. By now, the filing of stabilizing reports has become pretty much a matter of mere routine on the part of the three-hundred-odd firms who regularly underwrite security issues. The fact that my letter of the 27th actually did help Eberstadt & Co. is shown by the entirely correct report which it filed shortly thereafter.

I might also add that another result of my letter of the 27th—and one which I hoped it would achieve—is that the stabilizing reports which Eberstadt & Co. filed on its next operation came in on time and correct in all details.

Finally, may I point to the last paragraph of my letter of the 27th to Eberstadt & Co., which was not read, and which reads as follows:

If you encounter difficulty in applying the provisions of the rule to the transactions in question, may I suggest that you confer with the regional office of the Commission at 120 Broadway—

that is just around the corner from Eberstadt & Co.'s office—

New York City, which will be glad to render any assistance in this respect which you may require.

Thank you.

Senator Hughes (presiding). Thank you, Mr. Greene.

The committee will recess until 2:30.

(Thereupon, at 12:45 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTER RECESS

The subcommittee resumed at 2:30 p. m. on the expiration of the recess.

Senator Hughes (presiding). The subcommittee will resume. We will count Senator Herring present without his being here, and Senator Wagner will be delayed a little while. I hope to have him with us later.

You may proceed, Mr. Schenker.

ADDITIONAL STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Schenker. Senator Hughes, before we start discussing the specific provisions of the bill you have under consideration, I will try to answer some of the difficulties the investment trust industry have had with the bill.

I would like to make the record clear on one point: Yesterday when I discussed the experience of a stockholder in the Lehman Corporation, I said that $8.80 per share for each share outstanding at the present time was attributable to the fact that the corporation bought back about 33⅓ percent of its outstanding shares at a discount—that is, at a price below the asset value. That discount aggregated about $6,000,000. If you divide it among the number of shares outstanding you get $8.80.

I think in fairness I ought to make the additional observation, that by virtue of the fact that they used the money they did use to retire their own stock, the fund which they could invest was decreased by that amount. In other words, the money they used to buy back their own stock and retire it, of course was no longer available to them with which to make investments.

When we studied the Lehman Corporation I think the Commission made some calculation with the representatives of that corporation. I think it was established then that had they used the money which they did use to repurchase their own stock, and made the same type of investment they had been making, they would have made an amount equal to $8.80 per share.

Senator Hughes. Were those their own shares that they did buy back?

Mr. Schenker. Yes, sir; those were their own shares.

Senator Hughes. Were those shares offered for redemption voluntarily?

Mr. Schenker. No.

Senator Hughes. Or did the company seek to buy back its own stock?

Mr. Schenker. The Lehman Corporation is a closed-end company, you will remember.

Senator Hughes. Oh, yes. I now recall that it is.

Mr. Schenker. Their stockholder has no right of redemption. What the Lehman Corporation did was to go into the open market. It bought its shares on the New York Curb or the New York Stock Exchange. I do not think you were present at the time I was discussing that subject.

Senator Hughes. No; I am sorry I was not.

Mr. Schenker. In my statement I showed at what price they were buying back their stock. This was money they used to buy their own stock back in the open market from their own stockholders, most of which repurchases took place in 1931, 1932, and 1933. It was approximately 3 years after Lehman Corporation organized in September of 1929.

Senator Hughes. Then the stockholder had no option about it. They were not buying it directly from the stockholder but in the market. However, they were using the money of the corporation to do it. It was done as a policy, I take it?

Mr. SCHENKER. Yes, sir. The stockholder had no right to compel the corporation to buy the stock back. The corporation did it voluntarily, and of course the stockholder sold his shares voluntarily.

Senator HUGHES. I understand.

Mr. SCHENKER. There is only one other point I wanted to make: Senator Taft asked about the discount at which closed-end companies' securities are selling at the present time. We indicated that, for instance, the Lehman Corporation's stock today sells at about a 25 to 30 percent discount. That means that if a share of stock has an asset value, we will say, of $1, it is selling in the market at only 70 cents.

Senator Taft made inquiry as to what we attributed this discount, and as to whether it was not due to the tax feature.

It is pretty difficult to determine or to attribute it to any particular cause, but I do think your record should indicate that before there was any tax discrimination between closed-end and open-end investment companies, which took place in 1936, stocks of closed-end investment companies were selling at a discount. They were selling at a discount in 1932, 1933, and so on.

So I do not think you can attribute the entire discount to the tax exemption granted to open-end investment companies. I think there is some element of the public's appraisal of the management of closed-end companies in the discount.

Now, Senator, may we go to the bill?

Senator HUGHES (presiding). I ought to return to the Senate Chamber to vote on a bill that is coming up in a few minutes. The clerk of the committee has notified me of a vote. Suppose we suspend for a few minutes while I go to the floor and vote.

Mr. SCHENKER. All right.

Senator HUGHES. Perhaps Senator Herring may come along in the meantime——

Mr. SCHENKER (interposing). We will wait for you.

Senator HUGHES (continuing). And you may proceed as though I was sitting near by.

Mr. SCHENKER. We prefer to have you here.

Senator HUGHES (presiding). I will be back in a few minutes.

(Thereupon at 2:55 p. m. the subcommittee took a short recess.)

Senator HUGHES (presiding). All right, gentlemen.

Mr. SCHENKER. Senator, the first section that was discussed in detail by the industry, as I recall it, is section 5. There was not much discussion or any discussion on sections 3 and 4, and there was evidently no comment on those sections.

On section 5, what were some of the difficulties? There was some discussion about (b) on page 10, with respect to our definition of a diversified investment company; and in connection with that definition some of the witnesses, particularly Mr. McGrath, had some observations on (b) (1) (B), about the 85-percent provision. He felt that possibly the reservoir in which they can invest not more than 15 percent of the assets of the company in underwritings and so forth should be increased to 25 percent.

Now, Senator, this diversified investment company was what we visualized as the simple company which does not put a substantial part of its money into risk capital or venture capital but is going to give the public diversification in seasoned securities. Really the only

reasons why we made the provision for the 15 percent—and there was some feeling that it should not be even 15 percent but should be the type of company that has just diversified securities—were two: In the first place, we wanted to make some provision for a reservoir, so that if that type of company wanted to make available venture capital or risk capital, it could so do. However, we also had in mind that if we were going to make the reservoir 25 percent, a substantial part of that person's money is being subjected to that type of risk. That is one reason why we were persuaded not to go as high as 25 percent.

The other reason is a factual one or historical one. The fact of the matter is, Senator, that if you study these companies you will find really two broad classes with respect to the type of investments they make. There are companies that have 100 percent of their money in diversified securities and companies which have about 90 percent in undiversified securities and which use 10 percent for venture capital. And then there is the other type of company which has big blocks of stock and where they have a controlling influence in the portfolio corporation. This 85-percent provision has two bases: One, we felt that a company that can subject a person's capital, to the extent of 25 percent of his investment, to venture capital risks should not have the name of diversified investment company for then it is quite substantially a finance company. The other thing is that most companies which we concede to be investment companies can fall into that category. It is the natural division.

On the 150 percent portfolio turn over, as we stated to you when we presented our affirmative case, we were not unmindful of the problems with which the industry dealt at great length. We indicated that we were conscious of these emergency situations. My recollection is, from all the testimony, that there is not any violent dispute as to the principle that a person ought to know whether he is going into an investment company or going into a pool or a trading company. We do not say he cannot go into a trading company or a speculative company, but that type of company should not bear the label of an investment company. It ought to have a different name. On that problem of the 150 percent, we thought that possibly the industry would have some idea regarding how to meet the problem. We got the criticism, all right; but I do not recall the affirmative help on that subject, Senator.

I think we can work that out with the industry. Possibly in order to meet these emergency situations, you ought to make the period a little longer: That is, if it exceeds the 150 percent ratio, over 2 years instead of a year; or perhaps we ought to put in a little rubber and a little elasticity to meet the emergency situation.

I do not think there is any dispute that there ought to be a distinction between an investment company and a speculative trading company. That is just a matter of language. As far as we are concerned, add just some additional clause which will say that if you happen to overstep the 150 percent, you are not violating the law, under certain circumstances.

With regard to the 15-percent reservoir, there was some analysis to the effect that if an investment of 15 percent was and the market value of the investment went up, the company would not be able to make another investment in the reservoir. Well, under our

definition of value, if the securities do not have a ready market, then it is valued on the basis of cost; and if you are going to use venture capital and go into small situations, they are very unliquid—and therefore, in our opinion, under the definition of value—you could use cost. On the other hand, if there is any doubt about that, we have no difficulty in saying that it should be on the basis of cost rather than on the basis of market value. I do not think it is a matter of great significance.

There is another point on that, Senator, on which we shall elaborate a little bit when we discuss in more detail the nature of open-end companies and what their problems are and why we approached the open-end situation as we did. You must appreciate, Senator, that an open-end company is subject to demand liabilities—if tomorrow morning all stockholders demanded their money they could get back the value of their investment; the company could hold them off a day or two, depending upon the provisions in the indenture. Necessarily to meet that situation open-end companies must hold liquid securities; there cannot be any great amount of illiquid securities.

In my opinion, whether it is 15 percent or 25 percent, that is entirely academic as far as the open-end companies are concerned; they just cannot use a substantial portion of their funds as venture capital. I shall discuss that later on. They cannot go into underwritings; they do not go into underwritings; and that type of company just does not lend itself to that activity.

We feel strongly that a 15 percent reservoir, if a company wants to call itself an investment company, is sufficient.

With respect to the category of securities trading companies, there was quite an elaborate discussion of that subject, as I recall, by Mr. McGrath and Mr. Quinn. As I remember it, the basis of their objection was substantially that the S. E. C., by virtue of this provision, is fostering a deception or is encouraging a misleading situation because the only distinction between the diversified investment company and the securities trading company, in the instance they cited, is that the securities trading company may have only senior securities yet the companies would have different designations; that is, they may have the same portfolio and may have limitations of 5 percent in one company and not more than 5 percent of the outstanding of any company, just because that company has preferred stocks and debentures it is a securities trading company. Our recommendation is that they must call themselves a securities trading company; whereas if the company did not have senior securities and debentures, it could call itself a diversified investment company. There was a great deal of elaboration on it and indications of how the name was misleading.

Of course, I assumed that when they got through, they would say, "The name securities trading company is misleading, therefore change the name."

However, they did not say that. They say, "Therefore, let down the bars completely, and no matter what the company's portfolio is and no matter what its investments are, the company should be called a diversified investment company."

They could not understand why a company with senior securities, although it has the same portfolio and the same activities as a diversi-

fied investment company, should be called a trading company and not be called a diversified investment company.

There are two reasons that persuaded us to do that: In the first place, we visualize the diversified investment company as the sort of basic company in the industry—a simple company without any elaborate structure, one class of stock, diversification, no rapid trading. That is the basic company.

Now, therefore, some distinction had to be made between that type of company and the type of company that does not have a simple capital structure. That is the first reason.

Reason No. 2 is—and I may be wrong about that, but this is my concept—that if they have senior securities, the company is a margin account. If it is trading in securities on margin, just as if it were running a margin account in a brokerage firm under our concept that company is a trading company. If it had one class of stock, you could say it was an investment company.

As soon as senior securities are in the capital structure; as soon as the company buys securities on borrowed money, then in my opinion the company is no longer an investment company. You no longer have a mutual company. Under our concept that type of company is then a trading company.

Now, Senator, perhaps the name can be changed. The principle is clear. The type of company, which we feel is the basic company, is the company that has one class of securities; all security holders are on a parity, everybody takes the same risk, there are no conflicts of interest between the debenture holders, the preferred stockholders, the common stockholders. It is a mutual enterprise. That is the basic company.

Any company that deviates from that basis should bear a different label. That is the philosophy of that section.

The securities finance company is the type of company that is not subject to the restrictions of 5 percent and 5 percent. I heard a lot of talk here about venture capital and limitations on venture capital and limitations on underwriting. Senator, they could raise $100,000,000, under this bill, and put every nickel of it in underwritings, or they could loan $100,000,000 to any industry, big, small, or anybody else; all the company has to do is to tell the stockholders that that is its business, and call itself a securities finance company.

What they want to do is to bear the label of an investment company, which would indicate that they are an investment company, and not be subject to the limitations which the popular mind conceives that an investment company should be subject to—small blocks and diversification.

What they want to do is to be able to go into these risks, and venture situations, and yet bear the same label as a company which is going to go into diversified situations. There is nothing in this bill that in the slightest prohibits an investment company from going into underwritings or venture capital. The only thing this bill says is that, "You have got to tell your stockholders that that is your business, and you cannot bear the label of investment company."

I do not recall any difficulty with subsection (c).

Senator HUGHES. May I ask you how many securities trading companies and how many finance companies there are? Are there a great number of them?

Mr. SCHENKER. Yes, I think I can help you on that, Senator. The fact of the matter is that when you consider the number of companies which are in this finance activities, with which Mr. Glore of the Chicago Corporation is concerned, in my opinion you can count them on one hand and still have a couple of fingers left, do you see?

That is, even before the 1933 act and before the 1934 act, the number of companies that did financing was negligible; and the few companies that did that did not have a very happy experience. We shall develop that a little later.

The answer to your question, Senator, is that there are very, very, very few companies that do that with a substantial portion of their assets. Lehman Corporation does a little of it; Chicago Corporation does a little of it; the Atlas Corporation does a little of it; perhaps the Phoenix Securities Corporation does a little of it. However, aside from those situations, there are no companies that engage in that type of activity to any appreciable extent. The rest of the companies buy seasoned securities on the New York Stock Exchange; and that goes for fixed trusts, that goes for open-end companies, and that goes for closed-end companies, Senator.

Does that answer your question?

Senator HUGHES. Yes; that is all right, thank you.

Mr. SCHENKER. Thank you.

The next subsection upon which there was a good deal of discussion is (d) on page 11, Senator. On that section, Senator, in my opinion—and perhaps understandably—the industry read into that subsection a very great deal that was not intended to be put in there or, in my opinion, a great deal more than the language used in that section actually embraces. An effort was made to infer that this section was going to give the Commission the right to tell these people how to run their business, what securities to buy, and what not to buy, and so forth.

There are certain situations, Senator, that I think may have to be dealt with; and judging by a few of Senator Wagner's questions, I think he had the same difficulty.

May I give you one example, Senator: You can have a company which buys small blocks of steel, small blocks of railroads, small blocks of oil companies, utilities, and so forth; that is a diversified company, in that it diversifies into various industries, and even within the particular industries it can buy into different companies.

Now, you have some companies like Mr. Eberstadt's company that invests all its money in chemical companies and allied industries. He diversifies among chemical companies, but he does not diversify among the industries of this country. Some time it may prove misleading if the name "diversified investment company" is used. They may get the feeling that it is a diversified company in the broader sense—that he invests in every industry, rather than among companies in a single industry.

This subsection just provides that the Commission shall have the right to make further classifications, according to certain standards; and the important thing is that they must be consistent with the definitions contained in this section and in section 4. We just cannot create new classes that conflict with the classes that Congress created; and that is all that subsection is intended to mean.

On section 6, which deals with the exemptions, there was no difficulty up to subsection (c) on page 13, which contains the much-discussed provision to the effect that the S. E. C. has the power completely to exempt anybody, any security, any company, any time.

I think Judge Healy would like to say a few words about that subsection.

Senator HUGHES (presiding). All right, Judge.

Mr. HEALY. One of the problems was to try to determine what companies ought to be subject to this statute and what companies ought not to be. It was not an easy subject; and if you will look at section 3, at page 5, in subdivision (b) and the following divisions, and then look at the exemptions in section 6, you will see that there are a good many companies, which, either by exemption or by exclusion, according to the definition, are not subject to the act.

Due to the experience that we had under the Exchange Act, it seemed possible and even quite probable that there might be companies—which none of us has been able to think of—that ought to be exempted. Therefore, this section was written.

Of course, the Commission would not go to the trouble of getting up its recommendations and undertaking to defend them, and then turn about—as one witness suggested might be done—and let out everybody and proceed to enable everyone to be exempt from the provisions of the act and from the operation of the act. That would not make sense.

So far as we are concerned, this was put in here, not to give the Commission additional power or prestige or anything of the sort, but simply so that we could deal with the unpredictable situation where a kind of company turned up—a kind such as none of us had thought of—that ought not in fairness be made subject to the statute.

There are various ways in which that situation can be handled. The committee can completely throw out that provision; and if the committee does so, such a procedure probably would relieve the Commission of the burden of passing upon a good many cases that will not have any merit, and we shall no shed any tears over it; we can stand if it if the industry can. I doubt very much if the industry can.

The second thing that might be done is to pass it in its present form.

The third thing that might be done is to rewrite it and to make the standards somewhat tighter. The standards that are in here, I am convinced are legally sufficient; but whether as a matter of policy they are sufficiently definite and whether they are spelled out with sufficient clarity, I would not attempt to say.

Of those three courses, I think the one that I would be most willing to recommend would be the third course. However, we shall find no fault whatever if the section is completely stricken out. It does not help us any; it is simply designed, as I said, to give us the opportunity to let out a company that in fairness and in justice should not be subject to the act.

Senator HUGHES. If you left them out, Judge, that would leave them to the wording of the statute and the regulations that are prescribed by the statute, and there would be no flexilibities?

Mr. HEALY. If you struck it out completely.

Senator HUGHES. Yes.

Mr. HEALY. And then if some company came along—a company of a type which none of us has heard about or been able to think

about—which in fairness ought not to be subject to this statute, we would not be able to do a single thing for it. I think it would be very unfortunate if the industry were made subject to too rigid a statute; and if that occurred as a result of the complaints and criticisms by the members of the industry themselves—having helped to put themselves in that position—it certainly would be somewhat shocking if they later criticized the act as being too rigid. If it is too rigid in this respect, it seems to me that it would be their fault.

That was based on actual experience of the Commission; and I should like to repeat what I said in the opening: That in the early days of the Exchange Act if we had not had rather liberal powers of exemption, I do not believe we could ever have registered the stock exchanges of the country and the thousands of shares and the thousands of securities that had to be registered on those exchanges, without serious interruption of business. The fact that the Commission had such liberal powers of exemption did help us and did help the exchanges over several rather rough spots.

Now I should like to speak for just a minute also about subsection (d); and again I am not going to try to defend the language, but I should like frankly to lay before the committee what our motives were in suggesting that section. It is based on some actual experience that we have had under the Holding Company Act; and that experience is this: There is a certain very large corporation in this country whose major activities are not at all in the utility field, but they do have investments in utility companies—investments of such a size that the figures are very large and impressive, taken by themselves, but in comparison to the total assets of the corporation are somewhat minor. That corporation is very much averse to being known as a registered holding company; and the nature of its business is such that my feeling is that they are entirely justified in taking the position that they do. There is not the slightest reason why the S. E. C. should have any jurisdiction over the activities of that particular company outside of the utilities field.

The result which should ensue from that situation is this: That particular company should be wholly exempted from the Holding Company Act, except as to the dealings between itself and its utility subsidiaries. I do not think there is any difference of opinion between the Commission and the industry, with respect to that.

Now the question is, How to accomplish it. As the Holding Company Act is written, it is extremely difficult to give the company the necessary exemption. Some of the lawyers claim—I do not know whether they are right about it or not; I have not given up hope of working out the situation—but some of the lawyers on our staff advise us that we cannot give that company an exemption unless it registers. In order to obtain the exemption—which we have not the least desire to withhold—they would have to register and then get exemption from certain sections of the act. In doing that, they would immediately get the label of a holding company—which they ought not to have.

In the face of that experience, we thought that something of the same sort might possibly be encountered somewhere along the way, in connection with investment trusts; and if there were a company that ought to be subject to some of these provisions and not be subject to others, then we thought that this kind of provision, which is not

in the Holding Company Act, would enable us to work out the desirable result: that without registration they could become subject to only those sections of the act to which they ought to be subject.

These are our motives; I think the motives are all right. My guess is that the language is appropriate to accomplish that. If it is not, it can be rewritten. If the committee and the industry do not care to put the Commission in the position, under this act, which will permit of more flexibilities than permitted by the corresponding provisions of the Holding Company Act, then I say again that the Commission can stand it if the industry can stand it; but I do not think the industry can stand it.

That is all I wanted to say about that.

Mr. Schenker. With respect to section 7, as I recall, there was no specific comment regarding its provisions.

In considering section 8, relating to the registration of investment companies, there was some expression of opinion with respect to one of the provisions contained in the section. There was some criticism of subsection (b) (1) (C), on page 18, which deals with the characteristics, amounts, and relative amounts of securities and other assets which the registrant has acquired and proposes to acquire in the course of its business. I think that comment was made by Mr. Paul C. Cabot.

The fact of the matter is that, as I understand it, it is precisely the language of the registration statements under the 1933 act. That does not bind them as to what they may do in the future. It just provides that you must state what your present intention is with rsepect to what investments you are going to make—characteristics, and so forth. Well, that is the substance of the 1933 act.

As I indicated during the affirmative presentation, we have made an effort to eliminate duplication; and if he filed under the 1933 act or the 1934 act, he could use those documents in his registration under this act.

Judge Healy will discuss section 9.

Mr. Healy. In connection with section 9, I should like to pursue the same method of presentation that I did in commenting on the other sections, and I should like to tell the committee what we were trying to accomplish.

What we were trying to accomplish, in view of some of the things that happened to various trusts, was to get rid of persons with criminal records, persons who were under injunctions from courts of competent jurisdiction for improper practices in connection with securities. We had no other motivation. In suggesting such provisions, we were not trying to regiment anybody; and we were not, under the guise of getting information for this purpose, laying any plots to inquire into private affairs of directors and underwriters—affairs which admittedly are none of our business.

Our purpose was simply to try to get that type of person out of this business—where such persons ought to be out of it. At the same time we were trying to make provision for the case of a man who within 10 years might have been guilty of a crime, who nevertheless had made a come-back and regained the respect of his fellowmen, and who should not in fairness be subject to the prohibition. If that objective is accomplished in some other manner, I see no reason why it should not be.

Therefore, if the proposal is that in section 9 you write a prohibition that a person who has been convicted within 10 years of this sort of

crime or a person who is subject to this kind of an injunction shall not occupy one of these positions specified in this section, I think that might be a very sensible solution of it. However, if you do that, having put that strict prohibition into the statute, then I suggest that you append to it another section providing that with respect to any person who finds himself in that unfortunate position, if he can establish before the Commission—the administrator of the act—that nevertheless it is not against the public interest for him to occupy that position, the Commission may then permit it; I think that may be desirable.

Mr. SCHENKER. There is just one further aspect on that subject: Just in order to get the record complete, I should like to introduce a short memorandum which contains a very succinct analysis of the banking laws of some of the States. We made an analysis of the banking laws of 27 States, and this memorandum contains the provisions with respect to registration of officers of banks, and comparable provisions; so that if the committee desires to follow the suggestion of Mr. Paul C. Cabot, who said he was in favor of registration of officers and directors, you will get some idea of what the banking law is in the various States.

Senator HUGHES (presiding). Very well; it will be received and inserted.

(The memorandum referred to, dated April 17, 1940, is as follows:)

MEMORANDUM ON REGISTRATION OF BANK OFFICERS AND DIRECTORS UNDER STATE BANKING LAWS

The banking laws of the following States have been examined: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, New York, North Carolina, Ohio, and South Dakota.

Two States, South Dakota and Nebraska, provided for registration and approval of officers in express terms.[1] A third State, Colorado, provided for approval of officers (and by implication for registration).[2] A fourth State, New York, provided for registration of director of savings banks in a limited fashion.[3] However, in addition to these four States, three States, Arkansas, Idaho, and Iowa, provided that the banking authorities might report to the board any officer he finds to be incompetent, reckless, or dishonest and if the board fails to remove the officer the members are liable for consequential loss.[4] An eighth State, Georgia, provided for the immediate removal of an officer or employee by the banking authorities if it finds him to be dishonest, incompetent, or reckless

[1] Sec. 6.0317 of the South Dakota Code of 1939 provides that, within 5 days of election of an officer, the election shall be reported to the State commission "together with such other information as may be required by the rules and regulations of the commission." If the commission refuses to confirm the election of the officer, the office shall be vacant; and, if the officer is permitted to act without approval, the bank may be liquidated.

Nebraska requires (Compiled Statutes, 1929, ch. 8-166) that the executive officer shall be a person of "good moral character, known integrity, business experience, and responsibility; and be capable of conducting the affairs of the bank on sound banking principles"; and it continues that no person shall act as an active executive officer without a license from the department which may revoke the license if the business is conducted in an unsafe manner. The failure to have a license is a felony, and the department may make and enforce reasonable regulations and prescribe forms to carry out the intent of the section.

[2] Colorado provides (Statutes of 1935, ch. 18, sec. 13) that no one shall be an officer, director, or employee, if convicted of felony or of violating the banking laws of any State or of the United States; and the banking commissioners shall have the power to refuse approval of such person for any position in the bank.

[3] New York provides in sec. 246 of the Banking Law of 1938 that the election of a trustee to a savings bank shall be reported to the superintendent within 10 days together with name, address, and occupation; that such trustee may not have been bankrupt and must not have previously made a general assignment to creditors, must be a citizen and a resident of New York, New Jersey, or Connecticut; and must have no unsatisfied judgment outstanding for more than 6 months which has not been satisfied at least a year prior to his election.

[4] Arkansas provides that the Commissioner shall report to the directors of the bank any officer he finds to be "dishonest, reckless, or incompetent." If the board fails to remove the officer, they are liable for any consequential loss to the bank (Annotated Statutes, 1937, sec. 714). A similar provision exists in the Idaho Annotated Code of 1932 at sec. 25.407, and in the Kansas 1935 Annotated Statutes, at sec. 9-158.

in the management of the affairs of the bank.[5] Thus, in addition to the States of South Dakota, Nebraska, Colorado, and New York, registration may be required in Arkansas, Idaho, and Iowa in order to permit determination of general competency since general incompetence is grounds for removal as distinguished from specific incompetence in Georgia.

The power of removal is, of course, not limited to the States just mentioned. Iowa provides that a superintendent may remove a director for failure to attend meetings (Code, 1935, at sec. 9224–C2).

Indiana (Statutes, 1933, sec. 18–220) provides for the removal of an officer or director for violation of the law or unsafe or unsound practices which have been continued after warning to desist by the authorities. If a person so removed continues to participate in the management, he is guilty of a felony. A similar provision exists in the Massachusetts law (ch. 167, sec. 5).

New York provides for the removal of an officer or director who has violated any law or regulation, or has continued unsafe and unauthorized practices, despite warning by the superintendent of banks (Banking Law of 1938, sec. 41). North Carolina in the 1939 code (sec. 223–C) provides for the removal of officers, directors or employees found by the commissioner to be "dishonest, incompetent or reckless in management of the affairs of the bank, or who persistently violates the laws or lawful orders, instructions and regulations of the Commissioner of Banks."[6]

Mr. Schenker. One other aspect of section 9, Senator, is this: You will notice in (4) on line 15 there is another class of persons who are required by that section to register; those are the distributors of the installment plans, and their salesmen. You must have that provision, even if you accept the modification suggested by Judge Healy that the officers and directors of investment companies may not be subject to registration; because these distributors are not investment companies, you see; and therefore the only way you can get them registered is by including a section requiring them to register.

So you would have to have a provision requiring the registration of the distributors of installment plans and their salesmen. The only reason the salesmen are included is because the installment-plan people told us, "You will do us a favor if you will register the salesman, so we shall have some of his background and if he has been thrown out of one company we shall know if he is the type of person we want to sell our securities."

In connection with section 9, Senator, the problem is not an easy one, although there is a great deal to be said for the approach suggested in having the statute read that if anybody has been convicted of a crime, he shall not be able to be an officer or director. Nevertheless, the committee may still feel—as some of the members of the staff feel—that the same procedure should be used with officers and directors as has been used with the registration of the over-the-counter brokers and dealers. In connection with the over-the-counter brokers and dealers, you have substantially a registration of the officers and directors of those companies; because if the over-the-counter broker or dealer is a corporation, information is furnished with respect to its officers and directors; and if the dealer is a partnership, information is furnished with respect to the partners. The fact of the matter is that the registration of the over-the-counter brokers and dealers is a simple thing.

In other words, I mean to say that all this talk about, "We can ask about everything that they ever did or who they are or hope to be" is

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[5] The Georgia Annotated Code, vol. 5, sec. 13–603 provides that the superintendent of banks shall have the right to require immediate removal of ny officer or employee who he finds to be dishonest, incompetent, or reckless in the management of the affairs of the bank, or who persistently violates the laws or lawful orders of the superintendent.

[6] Montana (1935 Annotated Statutes, ch. 24, sec. 6014.14) provides that no one convicted under the banking laws of the United States or any State thereof may be elected a director.

just a bugaboo, Senator; because we have registered 6,000 brokers and dealers, and on the basis of that registration the Maloney Act was passed and the Maloney Association was founded.

The registration statement for brokers and dealers is simple: What is your name, address, the form of organization; are you a partnership; if you are a corporation, give the date when you started your business; who are your partners; and, then, were you ever convicted of a crime?

That is the nature of that registration statement.

Yet you heard talk here, for days and days, about how, under section blank and in conjunction section blank blank, as supplemented by section blank blank blank, as implemented by section blank, maybe at some future date somebody will get the idea he is likely to ask one of the officers and directors about his private affairs, or something! That is not the experience of the over the over-the-counter dealers and brokers.

The fact of the matter is that we have registered 6,000 brokers and dealers on a 4-page registration statement. It is an effective way of getting the information. A person files his registration, and it automatically becomes effective; and if the application shows the person is a jailbird or subject to an injunction for security racketeering, then the Commission has to institute a proceeding to revoke his registration. Do not become frightened by all that talk, Senator, about snooping.

It is just a procedure for simple registration, to get some idea of the people who are going to manage other people's money. In the opinion of some of the members of the staff, the question of which approach to take with respect to officers, directors, and so forth, is a question which deserves the consideration of the committee.

Senator Hughes. You say there are 6,000 members under the Maloney Act?

Mr. Schenker. No, Senator; my recollection is that there are 6,000 over-the-counter brokers and dealers registered with the commission. Out of those 6,000, about 2,800 have already become members of the National Association of Securities Dealers. Those are the figures, as I remember them.

Senator Hughes. I know something about that; I sat on the committee then.

Mr. Schenker. Well, you heard Mr. Traylor's testimony. There was a lot of talk similar to his testimony when the Maloney bill was being considered—various objections, and so forth and so on.

Today the National Association of Security Dealers is an association of 2,800 members; and Mr. Traylor is perfectly willing to entrust to that organization a very vital aspect of his business. You know as much about the background of the association as I do.

Now coming to section 10, Senator: We should like to take a little time to see what this section is about and to see what its background is and to see why we took this approach and to find out what its objective is.

This section provides:

> After 1 year from the effective date of this title, no registered investment company shall have a board of directors or an executive committee more than a minority of the members of which consists of—
>
> (1) Affiliated persons of any one company other than such registered company.

What does that mean? In substance it means that no longer should an investment trust be an adjunct to somebody else's business. We have had situations in the past of a chemical company that organized an investment trust, and the board of directors consisted of the members of the chemical company. You had a battery company which organized an investment trust, and the board of directors consisted of the people of the battery company; and you had the Hopson Associated Gas system, which controlled an investment trust—and at sometime, Senator, if you have the time, we shall tell you that story. That investment company—Eastern Utilities Investment Company—was just an adjunct to the Associated Gas system.

This section says substantially that the time has come, in our opinion, when for the benefit of investors and the industry itself these companies ought to be fairly independent institutions, standing on their own feet, and not be tied to somebody's kite, as Judge Healy expresses it. That is subdivision (1).

Subdivision (2) evidently has created a little confusion in the minds of some of the witnesses. Subdivision (2) states—

> The majority of the board shall not consist of persons who regularly act as manager, investment adviser, broker, or principal underwriter of or for such registered company, or affiliated persons of such persons—

Some witnesses have stated that that paragraph has eliminated all brokers from the board and all investment bankers and that we have circumscribed the area from which you can select your directors.

Senator, the fact of the matter is that if you had a board of directors of 15 or 55, every single one of those persons on the board could be a broker. There is not one word in this paragraph which forbids brokers from being on the board. So that the 1,300 members of the New York Stock Exchange, if this bill became law, all are eligible for directorships in investment companies. Let there be no confusion about that, Senator. No matter what one may say, that is what this language provides. It does not say that brokers cannot be on the board of directors, that investment bankers cannot be on the board of directors. You can have a board of 15, and every single one of them can be an investment banker or a broker.

What it does say is that if the broker does the brokerage business for that investment company, if you get the brokerage, if you are the one who has control of the portfolio turn-over, if you are the one getting the management fees, which may depend on the type of activity you perform, then in that event the majority shall be independent of that person.

We did not even recommend that anybody who does the brokerage business cannot be on the board; there still can be a minority of people who regularly do the brokerage business.

We feel, and our study in our opinion, shows conclusively, that the person who gets the pecuniary benefits from the activities of the investment trust should not be in complete control of those activities. If he is getting the brokerage business, all we say is that there ought to be an independent board there to take a look to see what is going on. Now, Senator, this is not a novel idea. The fact of the matter is that Mr. Bailie, when he testified for us—and he was very helpful and followed our investigation very carefully—had a prepared statement which he read at our hearing. This statement was printed and, as Mr. Quinn said, was sent out to 45,000 of his stockholders.

I do not know if this is still the fact, but I believe that Mr. Bailie is still the chairman of the board of directors of the Tri-Continental Corporation, with which Mr. Quinn is associated. I may be wrong about this, but I think I asked Mr. Bailie whether he submitted it to his board of directors before he read it at our examination; in any event, the corporation printed the statement and sent it out to its stockholders.

Mr. Bailie says unequivocally in this statement which is captioned "Democratization of Management":

> The interesting suggestion has been made that present corporate practice in investment companies be democratized, to make the small shareholder's voice in the choice of directors less perfunctory and more effective. The value to be obtained by having such stockholders take a real and continuing interest in their company's affairs would be great and we are in favor of this objective.
>
> There are certain steps in this direction that we believe could be taken to advantage:
>
> "(1) By the practice of providing that a manager of the board be independent of the sponsors or managers."

That is the situation today in Tri-Continental.

Now, Senator, you have heard some talk that the effect of this provision is going to be that a person who bought Lehman Brothers management may be compelled to accept somebody else's management; that the Government is trying to sell the stockholders down the river to somebody else. Just do not be frightened about that, Senator. The fact of the matter is that Tri-Continental Corporation is known throughout this country as a J. & W. Seligman Co. company, and it has an independent board of directors. Everybody in the country knows that State Street is a Paul C. Cabot & Co. management, and they have an independent board of directors. Everybody in this country knows that National Investors is a Fred Presley Company and he has got an independent board of directors. There are other companies in a similar situation, and I can give you company after company like that. So that the fact that the person who is really giving the investment advice does not control the board does not mean that he is not giving investment advice to the company. The only thing it means is that there are going to be some members on the board of directors representing stockholders, to have some participation in the management of the company.

Now, I would like to just subdivide this problem into three parts, Senator, if I may. You will notice it provides that a majority of the board of directors cannot be persons who act as management investment advisers, brokers, or principal underwriters; and I would like to discuss the broker aspect, first, and then discuss the manager aspect, next, and then the principal underwriter aspect next.

If I may go back for a second to the brokers. The bill provides that the majority of the board cannot consist of affiliated persons. What is the significance of that provision? If you have a board of directors on A investment company, it means a majority of the board of directors of B investment company cannot consist of directors of A company. There is nothing here that prevents a minority interlock; and I thought after we discussed this with the industry we had made a very substantial concession, because, Senator, we feel, as many people in the industry feel, that even to have one interlocking director creates problems.

You have had witnesses here who said they had been on the boards of other companies, and they felt in their experience that it did not create any problems. I think Charles Francis Adams and Roger Amory, and so forth, testified to that effect. But, Senator, I would like to read a letter, which is in evidence in our public examination, from Mr. Paul C. Cabot to Mr. John C. Greer, Jr., dated January 11, 1929. Mr. Cabot is closely associated with State Street Investment Trust, and he has an independent board of directors [reading]:

In accordance with our conversation of yesterday, I am writing to confirm my ideas as expressed at that time in accepting a position as director and member of the executive committee of the National Investors Corporation.

It is my understanding that the following ideas are acceptable to you and the other officers and directors:

In the first place, it is understood that in becoming a director I am only assuming those responsibilities and duties that normally fall to the lot of any other director, and that as such I am not expected to sell or recommend for purchase various securities that may be issued from time to time.

In the second place, as I explained to you, I believe it should be clearly understood that my first duty is to my own companies and trust, and, secondly, to the present two funds of the National Shawmut Bank, and in the third place, to you.

He was on the board of directors of State Street: he was a director of the National Shawmut Bank Investment Trust, and they asked him to go on the board of directors of National Investors. Paul C. Cabot evidently had plenty of difficulty with such interlocks because he took the pains to put his position in writing, and said: "I want to warn you that my first duty is to State Street. Then I owe my second duty to the Shawmut Trust, and the third to you. If you want to take me on that basis, all right."

So that the problem is created simply by the fact that you are on two boards of directors of companies in the same business, buying the same securities and engaging in the same activities. Necessarily there are problems.

Now, we did not recommend to this committee that a person cannot be on the board of directors of more than one company. We even permit the interlocking of a minority. We only said that when it comes to interlocking majority of directors you certainly have problems, and it was our recommendation that that be not permitted.

Let me go back to the brokerage business for a moment, if I may, Senator.

What are the problems in connection with the broker relation with an investment company? The ordinary investment company, Senator, is nothing but a large discretionary account. There is no limitation on what securities it buys, how many securities it may buy, when to buy them, how often to buy them, how often to sell them. But if you have a situation, as you have in some instances where the board of directors consists only of partners of a brokerage firm, then what have you got? You have got a discretionary account.

The New York Stock Exchange, in connection with discretionary accounts with brokerage firms, where the problem, in my opinion, is not even as acute as an investment company's because you are dealing with an individual customer who can see what is being done in the account, takes pains to set up protective features in those accounts. The only thing we are saying is that a similar procedure ought to be followed in connection with an investment company. If a person or his firm is the broker for the investment company, then he cannot control the board.

We also say, as Mr. Bunker, as I recall it, indicated, that the executive officer, the person who has some control or discretion in connection with the execution of orders, should also be independent, because in many instances wide discretion is given to that executive officer. The board of directors may pass a resolution saying that "We think we have too many common stocks. Get into cash. We want you to shift from common into bonds," and leave it to the investment officer to make up his mind as to the amount of the shift and when it should be done.

All that provision says is that if you get the brokerage business you cannot control the extent of the brokerage business; you cannot control the board of directors.

There is another aspect to this problem that I think you have to keep in mind, and that is this, Senator. Investment company brokerage business is the best type of brokerage business in the world. The business consists of big blocks sold for cash; no margin accounts; the customer is solvent. More important than that, you do not need any elaborate research division to give investment advice to investment companies. You do not need any customers' men; you do not need a big office, you do not need to go out and get business. You have this large discretionary account that is considered the best type of brokerage business.

I don't want to be misunderstood, Senator. I have been in pretty close contact with everybody in the investment company industry, and they know I am not making any general charge. I think they will agree with me that in some instances, Senator, particularly in times of distress, there might be some motivation to do a little trading just to get the brokerage business.

It seems from our study that the brokerage business in connection with the investment-trust industry has always been an important element. I think Mr. Smith will discuss that in a little more detail in a few moments.

I know Mr. Bellamy and have the greatest regard for him. I know Mr. Dominick, and I don't want it to be even inferred that I am making the slightest imputation. But the fact of the matter is—I forget now what the total assets of National Bond & Share are, it is not a very big company, 10 to 20 millions—the fact is that the total brokerage paid in 10 years to Dominick & Dominick was $1,039,266. All of the directors of National Bond & Share Corporation are partners in the brokerage firm of Dominick & Dominick. That firm sent out a letter to the stockholders of the investment company. I read that letter. It even frightened me, Senator. I could have drawn a little different letter.

What was the result? As I remember his figures he got about 200 replies, and 700 people refused to get frightened that the S. E. C. was going to ruin them. About 700 stockholders did not even bother answering the letter although they made elaborate preparations for replies: Self-addressed envelopes, and all the stockholder had to do was to answer "yes" or "no."

National Bond & Share can get Dominick & Dominick investment advice even if they do not control the board. This bill does not say that Dominick & Dominick cannot be investment advisers or cannot be the brokers for that firm. It just says that under those circumstances you have to be a minority of the board, and that the person

with discretion with respect to the execution of orders has to be independent of Dominick & Dominick.

Mr. Smith. The portfolio turn-over of National Bond & Share was as high as 7.44 times, whereas the average for most investment companies is not over 1.25. Their turn-over record is consistently much higher. I do not say they have not done a good job, and I am not attacking their integrity, but I think, as Mr. Floyd Odlum said, and as the Pecora report pointed out, brokers are in-and-out traders—point pickers.

That is one type of problem that comes from brokerage affiliation. Whether it is done in good faith or not or whether the person is a little bit unscrupulous, there is a risk.

The brokerage business is such a good emolument that investment policy in respect to the acquisition of other trusts may be guided by it. We have specific cases where it has. Even in a good trust in which I have complete faith in the management's integrity, like Tri-Continental Corporation, these conflicts may exist when it makes acquisitions. They started off in 1929 with one corporation, $53,000,000, and then they formed another one of $57,000,000 in August, and then in January 1930 they merged those two. During the depression they started buying up various investment companies. They got a $3,000,000 company in 1930. Whether this was part of the transaction or not, the fact is that the old sponsor who sponsored the Wedgwood Investment Co. has since had a right to 3.76 percent of the brokerage business of Tri-Continental Corporation. That, as I understand it, is not fixed by contract, but it is one of those understandings.

Then in April 1932, they took over Investors Equity, a $6,000,000 company. That company had been sponsored by C. D. Barney; and we find that the net result is that Barney has received annual brokerage commissions amounting to 5 percent of the brokerage of Tri-Continental Corporation.

That corporation, when it was bought out, was bought out because it had debentures outstanding and the touch-off clause was just about to operate, and the common stock was in process of being completely wiped out, and Tri-Continental Corporation was able to pick it up at a bargain.

Then in 1933 they acquired a $2,700,000 corporation which had been sponsored by G. M. P. Murphy, and we find that G. M. P. Murphy has since received a 5 percent interest in the brokerage.

Whether or not there is a different agreement, the fact remains that all these old sponsors who have sold their trusts to Tri-Continental Corporation are getting this brokerage business; and the brokerage business is the method of compensation of J. & W. Seligman as managers of Tri-Continental Corporation. That is the sole compensation that they get, so that the J. & W. Seligman Co. have a direct interest in the size of the fund and the amount of brokerage commissions.

They are also interested in good management, I am sure.

In May 1931, Tri-Continental Corporation acquired Selected Industries, a $53,000,000 corporation, and in connection with that C. D. Barney, the old sponsor, receives 50 percent of the Selected Industries' stock-exchange business. That is just as regularly as if there were a contract. I do not know whether there is any agreement; Mr. Bailie denied that there was; but the fact is that all these old sponsors get the brokerage business afterward.

In this case Tri-Continental Corporation paid a $2,000,000 premium to get the control of stock of Selected Industries. In the public hearing Mr. Bailie said, "We paid that premium. We expected to make it up in management fees to Tri-Continental Corporation."

Tri-Continental Corporation provided management for Selected Industries and said they expected to make up the $2,000,000 out of the management fees. They have not done it yet, and I think it will take many years before they do.

On June 10, 1932, Tri-Continental Corporation acquired, directly or indirectly, Broad Street Investing Co. and Capital Administration Co. They are investment companies with assets of $6,000,000. In connection with that not only did Maynard, Oakley & Lawrence, the original sponsors, thereafter receive 66⅔ percent of the Broad Street brokerage business, on assets up to $2,000,000, and 15 percent of all assets in excess of $2,000,000, but they also, when they were bought out, got, if my memory is correct, about a 300-percent profit on their original investment, whereas the investors in that company had lost a lot of money. I think they had lost 40 or 50 percent.

Another company that they acquired was Globe & Rutgers Fire Insurance Co.; and we find that Hayden Stone has received 15 percent of the stock-exchange business of that company.

I am not saying that there is anything improper about this case, because I have the greatest confidence in the management of Tri-Continental Corporation; but, nevertheless, that shows that brokerage is a problem of emolument, and that it has other aspects than just the question of churning.

I would like to point out a few other risks that come with this brokerage relationship. The brokers as a group, including specialists, do about 20 percent of all the trading in the country on their own account. In other words, they are big traders themselves. Then they do the rest of the business of the country, 80 percent, as agents. So you have the same group who are big traders trading on their own account, and then they are the agents for all the other people in the country, and then they are also the agents for the investment companies. We know that in some instances their purchases and sales may have quite an effect upon the market. The fact is we know that in September of 1939 the purchases during 2 or 3 weeks, of one investment company were greater than all the odd-lot purchases combined, and they amounted to an important factor in the market.

Those are only some of the risks. You have the fact that the typical broker operates with a relatively small capital. He can borrow up to 15 times, I think it is, his original capital. He makes his money to a large extent on margin accounts. A great many brokers do. So he represents a big credit risk. He owes a lot of people and he has borrowed that money back again from banks, so he is a risk from that point of view. We have had several examples, and I think I have already cited some examples, of brokers who were up against it and had to have money quickly, and they resorted to some direct or indirect transaction to save themselves.

Then, finally, I think there is another reason for having fairly strict supervision of brokers, both on the operating level and on the board level, and that is the fact that most of these brokerage houses are not only acting as investment brokers, but a lot of them are acting as investment counsel, and they are passing out the same information that they pass out to the investment company. They

are passing it to their brokerage clients and to the clients of the investment counsel service.

As I analyze the situation of the brokerage relationship with the investment company, they are engaged in exactly the same business, and the only question in my mind is whether we have gone far enough in providing for an independent majority and some independent person at the operating level where the broker wants to be the manager.

In connection with the acquisition of Broad Street, Maynard, Oakley & Lawrence got—I do not know whether it was a 300-percent premium or a 300-percent profit, but I will check it. I remember that their original investment was relatively small, and they got much more than their original investment out of it, several times more.

Senator Hughes. What did the stockholders get?

Mr. Smith. The two-thirds stock of the company holding the management contracts was sold to Tri-Continental Corporation and thereafter Tri-Continental Corporation supplied the management of the company at the operating level, although Maynard, Oakley & Lawrence and their group have since remained as a substantial majority of the board. Maynard, Oakley & Lawrence continued thereafter to get brokerage from the two companies that they had formerly managed. Tri-Continental Corporation in turn is managed by J. & W. Seligman, subject to an independent board.

Under the management of Tri-Continental Corporation each investment is in effect managed by J. & W. Seligman.

Just one further fact in regard to the importance of supervision at the operating level.

I notice that National Bond & Share, for 1 year—1934—paid brokerage commissions amounting to 2.86 percent of the average assets of the company. The usual management fee is one-half of 1 percent. I am not saying that that was not beneficial to the company. I think National Bond & Share has had a very good record; but I say that that illustrates the problem.

Mr. Schenker. Just one other point, Senator. There were the situations where people were associated with more than one investment trust, and there was a great deal of discussion to the effect that this legislation will affect them. They say, "We will have to give up one of our trusts," and so forth. The fact of the matter is, Senator, that this bill does not prevent anybody from having an association with more than one investment trust, even as manager in the broad sense.

I think a great deal of emphasis was placed here on "management," and I do not think there was sufficient indication that we drew a distinction between a "manager" and an "investment adviser."

A manager substantially is the person who not only gives investment advice but has really the power to take his own advice and execute the transactions. An investment adviser is an individual who gives investment advice to the board of directors. They can take it or leave it.

What we have said is that you can be the manager of one trust, and you can be an investment adviser of another or two others or three others. That distinction, we felt, was some protection against any conflicting interests. He can manage, he can take his own advice, and he can execute all transactions for one investment company. If he is associated in a similar capacity with another invest-

ment company he can give advice, but there must be some directors independent of him who can refuse to take the advice.

So there has been a great deal of discussion, as I said, with respect to managing more than one investment trust. The fact of the matter is that they can give investment advice to more than one investment trust.

Now, Senator, Mr. Cabot is in that situation. I think you heard him testify. He said this bill does not touch him except in one small instance. Mr. Cabot is the manager of State Street, and he is the investment adviser to the Shawmut Bank investment companies. This is really a codification of the practice that Mr. Cabot has been following, of acting as manager of one company and investment adviser to the others.

I would like to go on with reference to paragraph (b) on page 23.

In order to cover a situation like Tri-Continental Corporation, we have permitted interlocking directors if they are in the same investment-company system. If A company is controlled by B company which, in turn, controls C company, there can be interlocking directors in that situation.

Then we go on to say that where the relation involves a bank, you can have an interlocking majority. The big point was made, "If it is all right to have interlocking directors with a bank, why do you forbid it in the future? This provision permits the status quo interlocks, but in the future you cannot have that type of situation."

Well, I don't understand that argument. The study showed that interlocking relationship between investment companies and banks was a very unhealthy relationship, both from the point of view of the bank and from the point of view of the investment trust.

Senator Hughes. Is not that a broad statement, that you can have interlocking directors of banks?

Mr. Schenker. There can be an interlocking director between the bank and the investment company.

Senator Hughes. The statute applies to other banks. There cannot be a director of two banks.

Mr. Schenker. That was one of the things that persuaded us to feel that the same prohibition ought to apply to investment companies; but we did not recommend that you go that far. We do permit the interlocking of minority directors; but with respect to interlocking between a bank and an investment company we do not disturb the existing situation, although our study shows that it is not very satisfactory as far as the investment company or bank is concerned, to put it mildly.

However, because of the delicate relationship between banks and investment companies, we said we would not recommend that the status quo be disturbed; whereupon, after making that concession, the industry argues that if the status quo is all right, why should not new such relationships be permitted in the future?

That is the nature of the argument you heard here. I will not elaborate my answer.

Mr. Smith. I think there is nothing so clear as the fact that this relationship between the banks and the investment companies has proved unfortunate. The president of the Liberty Bank said that there ought to be absolute segregation. The head of the M. & T. Bank said the same thing. The head of the Central Illinois said that

the relationship was unsatisfactory. I do not think there is any question about it as far as our record is concerned.

Mr. SCHENKER. The directors of the Chatham & Phoenix Bank, which also had an investment trust, said it was a very undesirable and unfortunate relationship.

However, there are one or two such situations which are still left, and we recommended that they be not disturbed, but that the relationship should not be permitted to be created in the future.

With respect to the relationship between investment counsel and investment trusts, you probably heard the testimony of Mr. White, of Scudder, Stevens & Clark, and Loomis-Sayles. Mr. White had specific provisions which he thought should be imposed; and I think they merit consideration. I do not think there is any useful purpose subserved in elaborating upon that particular peculiar situation.

Senator HUGHES. I did not hear Mr. Cabot's testimony.

Mr. SCHENKER. Mr. White said substantially that he had——

Senator HUGHES. I heard Mr. White.

Mr. SCHENKER. We now get down to subsection (c) on page 24 of the bill, and Mr. Smith wants to discuss that subsection.

Mr. SMITH. Subsection (c) and subsection (e) (2) and subsection (f) are all closely related. They all apply to the investment bank relationship to investment companies.

Usually the investment banker is also a broker, so that you have not only the problems that arise from brokerage—I should not say that every investment banker is usually a broker, but a great many of them are—you have the problems that arise from brokerage and also the problems that arise from the underwriting business.

In subsection (c) we provide that an investment banker or broker shall not serve on more than one investment company. In other words, one investment company is enough for an investment banker or broker.

That ties in with subsection (f) which says that an investment banker cannot do underwriting if the investment company owns more than one-half of 1 percent of any class of securities outstanding of a portfolio company.

In other words, if an investment banker is on an investment company and the investment company owns more than one-half of 1 percent of an industrial company, he cannot get the underwriting business.

It is quite obvious that if you have investment bankers on a number of investment companies, aside from other reasons, that provision would be evaded because he would very quickly build up a large percentage of control through a series of investment companies; and our experience has been that investment bankers do not confine themselves to one investment company, but they have gotten into whole series of them.

I think you will find that Lehman Bros. have been connected with five or six. That is covered in chapter I, part 3.

If you are going to have any restriction upon underwriting—and Mr. Bunker agreed that some restriction might be wise, and suggested 5 percent—we suggest one-half of 1 percent. It seems to me that you have also got to take into consideration some restrictions upon the number of investment companies that the investment banker can be on, because there is a tendency for investment bankers to put the securities in which they are interested into their portfolios.

Some people have said that an investment trust that is sponsored by an investment banking firm is no better than the clients of the investment banker. That sort of investment may be done in good faith, because they think they know about it, but the fact remains that they do do it, and where they are connected with more than one trust you find the same issues.

We have given you a list of cases of companies whose managements are open to some suspicion. On the other hand, I would like to point out the situation as it exists in a good type of company, the Lehman Corporation, as of December 31, 1930.

I point this out: Four of Lehman Bros. are directors of General American Corporation, another investment company, Mr. McGrath's investment company. You will find that 62 of the total of 193 issues in Lehman Corporation's portfolio were also in the portfolio of General American Investors Co., which had 102 issues in all. In other words, 32 percent of Lehman's issues overlapped General American Investors, and 60 percent of General American Investors' issues overlapped with Lehman Corporation.

Senator Hughes. A man might think well of some particular issue. If you had made a careful study of some security and came to the conclusion that it was a first class thing to invest in, and somebody comes along and asks your advice about it, you would naturally think well of it.

Mr. Smith. That is correct. That ties up with the issues that they underwrite. I can give you another example of that same sort of an interlock—Hayden-Stone and Hallgarten, in 1929. Hayden-Stone were the sponsors of Adams Express, and there was a general sponsorship of Hayden-Stone and Hallgarten of two investment trusts, and there was a 40 or 50 percent overlap there. The significance of it is that that overlap very often consists of securities in which investment bankers are also interested from the point of view of underwriting. That complicates the problem.

As you say, it is obvious that if a man is on both boards he may recommend the same securities. But you may also get the increased impact of the underwriting problem—the relationship of the investment banker using the investment trust to help him with his underwriting business when his issues appear in more than one trust.

Taking Lehman Bros., since 1936—and they disclose this in their reports—they have acted as underwirters for at least 51 security issues for companies whose securities were in the portfolio of Lehman Corporation.

I can go down through the list of those corporations. They are big ones, and many of them they would have gotten anyway; but there is no question that it helps to have an investment company have a big block of stock or bonds in the company from which you want to get underwriting business. The underwriter has various interests in having his investment company hold blocks of stock. First, it can be a "bird dog"—a means of getting business. If the investment company sponsored by an investment banker buys into an industrial company he can use his position as a means of getting either on the board of, if he has got the underwriting business, he can put a block of the stock of the industrial corporation into the investment company in order to keep the business.

He is also interested in keeping his capital free, because a typical underwriter, as I pointed out earlier, keeps turning over his capital

very quickly and he cannot afford to have his money tied up in securities that have become a little slow. It has been shown that as to 17 out of 57 issues in which an investment company had 1 percent holdings, the investment banking sponsor got underwriting business. That ratio is higher than the amount of underwriting business they got from their smaller holdings; so the higher the holding the more chance there is of getting underwriting business.

In my reference to Lehman Corporation I have not tried to insinuate that there is any activity on their part in bad faith. I am merely trying to take a company whose management I think is trying to do an honest job, but still to show that the tendency is to have a close relationship between the banking business and the investment-company business.

Mr. Schenker. Just one thing more, Senator. I am sure that you would like the record to indicate that the fact that specific names were mentioned does not remotely mean that we are making any accusation that there was anything improper or wrong or reprehensible done. The only thing that Mr. Smith and myself were trying to indicate—at least, as far as I am concerned, and I am sure that it is true of Mr. Smith—was that there are certain problems by virtue of this relationship; and the fact that a name is used is no indication that that company is being singled out or has any standing other than any other company. Possibly the cases should have been given as suppositious situations. We are particularly anxious to have the record unequivocally show that the fact that names are mentioned carries no significance so far as the companies are concerned. We are just discussing the problems that are presented.

Mr. Smith. I agree with Mr. Schenker's statement in that regard, Senator.

Senator Hughes. You are not picking them out for condemnation because they are in that line of business. They illustrate a line of business.

Mr. Smith. That is right.

Senator Hughes. Were you going to say something, Judge Healy?

Mr. Healy. The situation down at my office is such that I am needed to make a quorum.

Senator Hughes. Suppose we take a recess until 10:30 tomorrow morning.

Mr. Healy. Is there any chance to get going at 10 o'clock.

Senator Hughes. So far as I am concerned. I think I could, but I do not know what the chairman may think about it. I can stay half an hour longer at this time.

Mr. Schenker. Then we can finish with section 10.

You will see on page 25 of the bill, Senator, we deliberately inserted a provision permitting persons, who may not act as managers, to act as investment advisers. Although the definition of an investment adviser would have indicated that a distinction was being made between a manager and an investment adviser, we deliberately put into the section, starting on line 8, page 25, the statement that a person can act as an investment adviser for more than one company; or if he is a distributor he can act as investment adviser.

I would like to discuss briefly section (e) on page 25. This question of interlocking directors between an investment company and a portfolio corporation is not an easy problem. Judge Healy and I indicated on our affirmative presentation that we felt there were

problems created when an investment company which is supposed to be an investor in the corporation becomes tied up with the management of the corporation in the form of a directorship. What this section says is that the diversified investment comparies should not have any interlocking directors with companies in which they are interested.

Then you heard the analysis that by virtue of this provision we have immediately eliminated from participation in directorships of investment companies about 15,000 people who are the best brains in the country and who have the requisite business training for directorships, and so forth. I think it was Mr. Bunker who said there were 1,100 issues on the New York Stock Exchange. If you average about 15 on the board, there would be about 15,000 persons.

I know that Mr. Bunker will not misunderstand me when I say this, but the first thing I did when I went back after the hearing was to take a look at the board of directors of Lehman Corporation to see how many of these 15,000 people were on the board of directors of Lehman Corporation or how many of them had ever been on Lehman Corporation's board. I found, Senator, that not a single one of those 15,000 had ever been on the board of directors of Lehman Corporation except the partners of Lehman Bros. That is, these partners were directors in industrial corporations, but the only directors of industrial corporations who were on the board of Lehman Corporation were the partners of Lehman Bros. I may be wrong about that, but I found that throughout the entire history of the Lehman Corporation the only directors of industrial corporations and other corporations on the board of Lehman Corporation were the partners of Lehman Bros.

Senator Hughes. Do you infer that that is typical of others also?

Mr. Schenker. I think that is true of General American Investors Corporation, Mr. McGrath's company. I think the situation is that they have some directors of industrial corporations; but as I took a look at it—and if I am wrong I will let Mr. McGrath correct me—the investment trust did not have a single share of these companies in their portfolio; so those directors would not be disqualified under this section.

The question is, Senator, which is the chicken and which is the egg? Is the objection that we are keeping directors of industrial corporations off investment companies, or is the objection that the directors of investment companies cannot get on the boards of portfolio corporations?

There is a big difference, as far as the effect on the present situation is concerned. I mean, if you take the history of those companies—I think this is probably substantially correct—those companies would not have been very substantially affected by this subsection except in the sense that the directors of the managing company might not have been able to be on the portfolio corporation. I am not denying that it is quite an important problem for investment bankers. They are on the boards of a great many corporations. Yet that is the situation.

We tried to indicate what the problem was, and I think it has been as well stated by Paul Cabot as anybody else. Mr. Cabot was a little critical of Judge Healy because Judge Healy did not read his whole article. He read a portion of it, and Mr. Cabot said, "You didn't read the whole article." I will read another little portion, and it still won't be the whole article.

In this article Mr. Cabot was discussing some of the problems of investment companies, particularly the problem of interlocking directors between investment companies and portfolio corporations. What did he find? This article, by the way, is in the record. He says (reading):

In the other company almost any security will get by. The pet issue of each director and officer can find its way in. Director A passes Director B's security, although he may not be very enthusiastic about it, so that Director B will not blackball his issue.

And that is exactly the feeling we have from our study, and it is substantiated by what Mr. Cabot says (reading further):

Another disadvantage to the highly diversified portfolio is either the inability of the management to follow closely so many issues or the expense of so doing.

Then he goes on further to say this (reading further):

Some months ago I was asked by an investment house if I would consider running an investment trust that they had sold to the public some time before. During the course of the discussion I asked if I might see the portfolio. In examining this, I noted a very large block of the shares of a company which, as a banking house, they had recently acquired and sold to the public. I asked the gentlemen with whom I was talking whether, if I were to advise them on their portfolio, and if I could convince the directors that the shares of another company in the same industry were a preferable investment, they would make the exchange.

You will note that he is really discussing not only interlocking but where the investment banker is associated with the investment company:

He replied, "No, not necessarily. This trust is part of our general machine, and if the selling of these shares adversely affected"—

And there is a blank, evidently deleting a name:

"and Co. we would not make the sale." And yet the securities of this trust were sold to the public, whose money was being used not for the best interests of the men and women who had supplied the funds, but for the best interests of ——— and Co. This case brings up two common abuses to which the investment trust is now being put. First, that of being run for ulterior motives and not primarily for the best interests of the shareholders; second, that of being used as a depositary for securities that might otherwise be unmarketable. There are, of course, certain trusts that have been formed with avowedly ulterior purposes. Such procedure is obviously beyond reproach. It is only when trust says it is formed to accomplish one thing and then attempts to do another, that it becomes an abuse.

Senator HUGHES. Did he say that that was uncontrollable?

Mr. SCHENKER. His suggestion was, substantially—publicity. You know as much as I do, Senator Hughes, about the value of publicity to deal with this type of situation. We say it is not sufficient. That is the situation we are trying to deal with in section 10 of the bill.

I continue quoting:

The practice by which a house of issue sells a part of its own underwriting to its own trust, although not necessarily unethical and unsound, is extremely dangerous. Those trusts run by banks and brokers are particularly subject to this temptation. In my opinion such companies should have a provision or a firmly established policy that they will in no way deal with themselves as principals; that if they wish to acquire part of an issue in which they as a house may be interested, they will have to acquire it from some entirely outside source.

And we attempt to deal with that in section 10 of the bill.

So the problem is not new. Paul Cabot was conscious of it back in 1929, and our study shows that that problem still exists. I want to reiterate that the fact we talked about certain companies was just

to indicate what we were attempting to do in dealing with this problem also.

Just one other thing, Senator Hughes: We have a provision in the proposed bill that the managers, directors, officers, and partners cannot deal with the investment trust. This bill does not say that these people cannot be the brokers for that company. I indicated that before.

Now, what is our approach? The provision requiring an independent majority of the board is not a tough one because if you take a situation which in my opinion is similar, insurance companies, you will find that the laws of various States have provisions that not only cannot an officer or director have a direct or indirect interest in any transaction as principal, but he cannot even have a direct or indirect interest in any transaction in which he acts as agent and gets a fee.

So that in the insurance company field it is my understanding—and I notice that Mr. Quinn looks at me a little quizzically—it is my understanding that if you are an officer or director of an insurance company you cannot be a broker for an insurance company. And I notice that Mr. Jaretzki shakes his head.

We do not go that far. We say he can be a broker, but that in this situation he cannot control the board and cannot be chief executive officer.

The statute to which I will now refer is broad:

> No director or other officer of an insurance company, and no member of a committee having any authority in the investment or disposition of its funds, shall accept, or be the beneficiary of, either directly or indirectly, any fee, brokerage, commission, gift, or other consideration for or on account of any loan, deposit, purchase, sale, payment, or exchange made by or in behalf of such company, or be pecuniarily interested in any such purchase, sale, or loan, either as borrower, principal, agent, or beneficiary, except that, if a policyholder, he shall be entitled to all the benefits accruing under the terms of his contract.

Senator HUGHES. What was that last sentence?

Mr. SCHENKER. That he shall be able to get the benefits of his policy. In the insurance field the law goes much further than this bill.

I will say for the benefit of counsel present if they want to check it, that I am reading from the statutes of New Hampshire relating to insurance; and I will read them from New York if it will make them more comfortable.

Prior to a very recent amendment chapter 30, section 36 of the New York law contained substantially the same language:

> No director or officer of an insurance corporation doing business in this State shall receive any money or valuable thing for negotiating, procuring, recommending, or aiding in any purchase by or sale to such corporation of any property, or any loan from such corporation, nor be pecuniarily interested, either as principal, coprincipal, agent, or beneficiary, in any such purchase, sale or loan—

and so on.

Now, on page 25 of the bill, under subsection (e) the problems dealt with by paragraphs (1) and (2) of course are different.

One is the problem which was discussed by Mr. Eberstadt and others: Why should not a person who is a director of an investment company be on the portfolio of the corporation; and (2) of course deals with the situation where that interlocking director is an investment banker.

Now, a great point was made that this paragraph (1) was very confusing, that it seemed to be suffering from astigmatism, because you would naturally feel if an investment company had more than 5 percent it would be in position to exercise a controlling interest. Well, we say, if the investment company has a small interest—does not have a controlling interest—the investment company cannot have a director on the portfolio corporation. If it is the business of the investment company to buy substantial investments in the portfolio corporation, if the business of the investment company is to acquire controlling interests, then certainly the company ought to have representation on the board of directors because that is the only way you can exercise the business purposes for which you invested. It is only where you say you are an investment company and you do not go in for control and therefore you limit your investment to 5 percent that we say in that circumstance you must eliminate all the problems that Mr. Cabot indicated and you shall not be on the board. You must stand aside, be able to scrutinize the activities of the portfolio corporation, and not be tied up with the management. That is the philosophy of that section.

Mr. Smith. Also may I say that the provision does not cut off industrialists from the board. It merely says, for instance, that if Mr. Chrysler comes in it is not to buy Chrysler Corporation stock. I will say that I had a personal interest in a trust fund and the bank had its own stock. That bank stock was held for a great many years, and went from 110 to 2. I asked why they did not get rid of it. They had the best information about it in the world. It ended up by their paying a surcharge to a certain extent on the income. There is the problem on that. But that is quite different from the investment-banker problem, which is a further complicating factor.

Mr. Schenker. Senator Hughes, I think this might be a good place for us to stop for the day.

Senator Hughes (presiding). That is satisfactory to me. I have been going since 10 o'clock this morning. The subcommittee will now adjourn until 10:30 o'clock tomorrow morning.

(Thereupon at 5:30 p. m. the subcommittee adjourned until 10:30 a. m. Friday, April 26, 1940.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

FRIDAY, APRIL 26, 1940

United States Senate,
Subcommittee on Securities and Exchange of the
Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator James H. Hughes presiding.

Present: Senators Hughes (presiding), Townsend, and Taft.

Senator Hughes. The subcommittee will come to order. Senator Wagner is unavoidably tied up in another very important matter that prevents him from being present this morning. He is counted present in spirit if not in the flesh, so as to make a quorum.

We are ready now to proceed if the witness is ready.

STATEMENT OF CARLILE BOLTON-SMITH, ATTORNEY IN THE GENERAL COUNSEL'S OFFICE, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Bolton-Smith. I am an attorney in the General Counsel's office of the Securities and Exchange Commission.

At the request of the investment trust study the general counsel's office lent me to conduct two hearings for the investment trust study; one with reference to an investment trust run by Mr. Cyrus Eaton of Cleveland, about which I shall speak this morning; and the other about an investment trust which was run by Mr. Hopson of the Associated Gas and Electric System.

Witnesses have expressed the opinion that if the bill before this committee requires that the majority of the board of an investment trust be independent, there is no need of further restricting the membership of the board.

It may throw light on these statements to tell you something of an investment trust, a majority of whose directors were independent of the firm which sponsored it. The facts I shall give you were brought out in a public hearing which I conducted before a trial examiner of the Securities and Exchange Commission as a part of the investment trust study. The witnesses were men connected with the investment trust and its sponsor.

Otis & Co. was a partnership engaged in the brokerage and underwriting business, with headquarters in Cleveland, Ohio. Mr. Cyrus Eaton had a 40-percent interest in the partnership and was its dominant partner.

In 1926 Mr. Eaton and Otis & Co. organized an investment trust called Continental Shares, Inc. Mr. Eaton acquired 15 percent of

the voting stock of this investment trust. In addition to Mr. Eaton, another partner of Otis & Co., and a member of Mr. Eaton's family became members of the board of 7 directors of Continental Shares, Inc.; and, although the majority of the board were independent of Mr. Eaton and his firm, Mr. Eaton became chairman of the board. His relative became president. Together they could control the executive committee. And Mr. Eaton was able to control the investment trust, with results beneficial to himself and Otis & Co.

And I should add at this point that Mr. Eaton controlled 26 percent of the stock of Foreign Utilities, Ltd., a private Canadian investment company.

Continental Shares had raised $111,000,000, mostly from the public. It had bought heavily in special situations in order to influence policies in large key companies; and by October 9, 1930, had been able to pay off almost all of its bank loans.

For some time, there had been talk in the Street about Otis & Co., and on October 10, 1930, Otis & Co. had about $11,500,000 of call loans called by New York banks.

About October 10, 1930, Continental Shares, Inc., agreed to purchase most of the portfolio of Mr. Eaton's Canadian company, at a valuation of about $57,000,000 of which $35,000,000 was to be paid in cash and the balance in stock of Continental Shares, Inc., the investment trust.

In order to finance this cash payment, Continental Shares, Inc. borrowed $30,000,000 from the Chase National Bank in New York, and $5,000,000 from the Union Trust Co. in Cleveland, Ohio. Of course, it pledged securities as collateral for these loans.

It was Mr. Eberstadt, the New York partner of Otis & Co., who negotiated this loan of $30,000,000 from the Chase Bank to Continental Shares, Inc., the investment trust.

By the night of October 13, 1930, which was only 3 days after the agreement whereby the investment trust was to purchase practically all of the portfolio of Mr. Eaton's private Canadian company, the situation with respect to Otis & Co. had reached such a pass that at a meeting between members of the board of governors of the New York Stock Exchange and representatives of Otis & Co., including Mr. Eberstadt, it was made clear that the New York Stock Exchange would not permit Otis & Co. to open for business the next day unless Otis & Co. raised $12,000,000 of new capital. This was shown by Mr. Eberstadt's testimony before a Senate committee. And this was confirmed by Mr. Eaton's own testimony before a trial examiner of the Securities and Exchange Commission.

It is interesting to note that at this time the books of Otis & Co. show that Foreign Utilities, Ltd., owed it about $12,000,000, about the same amount that the New York Stock Exchange required Otis & Co. to raise in the form of new capital.

By the next day, October 14, 1930, the $35,000,000 which Continental Shares, Inc. had borrowed from banks, had been paid to Foreign Utilities, Ltd., and Foreign Utilities, Ltd., had paid to Otis & Co. about $33,000,000, which Otis & Co. used to pay off bank loans.

I might explain that $12,000,000 of this sum represented capital contributed in the name of Mr. Cyrus Eaton, which he borrowed from Foreign Utilities, Ltd., for 8 percent plus a share in his profits.

In this way Otis & Co. met the requirements of the New York Stock Exchange that it raise $12,000,000 of new capital, and Continental

Shares, Inc., was caused to pledge portfolio securities to borrow the money from which this capital came. Foreign Utilities, Ltd., had paid its $12,000,000 debt to Otis & Co. and deposited with it a credit balance of about $21,000,000. Otis & Co. had paid about $33,000,000 of its bank loans.

In this way Otis & Co. was enabled to continue in business. On the other hand, Continental Shares, Inc., was never able to pay off the $35,000,000 of bank loans, from time to time additional portions of its portfolio were pledged to secure these loans, and, in June of 1933 the Chase National Bank foreclosed its loan, selling at auction the major portion of Continental Shares' portfolio, so that when Continental Shares went into receivership its portfolio was carried at only $16,500,000 gross and $6,500,000 net, after deduction of liabilities.

Although Mr. Eaton claims that the simultaneousness of these transactions was only "a striking coincidence" and that 15 months before he had thought of Continental's buying the Foreign Utilities' portfolio, the actual transactions speak for themselves. And over $8,000,000 of the $57,000,000 of securities sold to Continental Shares had just been bought from Otis & Co. by Foreign Utilities, so that Otis & Co. was indirectly selling over $8,000,000 of securities to Continental Shares.

I might say, incidentally, that Mr. Eaton's Foreign Utilities made a profit of over $3,000,000.

Besides, as reported in the memorandum from Mr. Sherrill Smith to Mr. Wiggin of the Chase National Bank of New York, Mr. Eberstadt told the Chase National Bank, when arranging for the $30,000,000 loan to Continental Shares, Inc.:

> the $30,000,000 loan will clean up their (Otis & Co.'s) biggest debit account which is Foreign Shares or Foreign Securities Co. (meaning Foreign Utilities, Ltd.). They have been buying utility securities and owing Otis. The proceeds of our loan to Continental Shares will go to Foreign Shares and from them to Otis. Eberstadt says he is satisfied that they have no other debit balances which are large enough to cause them any uneasiness.

Speaking of this same loan to Continental Shares, another Chase National Bank memorandum said:

> I really think we are doing Otis & Co. a big service——

And yet the majority of Continental Shares' board of directors was independent.

The effect of this sale of securities to the investment company, which had to borrow the money to pay for them, was responsible for the receivership of the investment company.

W. R. Burwell, former president of the investment company, testified:

> Question. And it was the failure of Continental Shares to pay off the $30,000,000 loan from the Chase Bank and the loan of $5,000,000 from Union Trust Co. that resulted in the foreclosure on Continental's collateral in June 1933, isn't that right?
> Answer. Yes.
> Question. So that if Continental Shares had not borrowed that $35,000,000 from the banks in October, 1930, it would have had no difficulty in retaining its Portfolio throughout the depression, isn't that right?
> Answer. That is quite true; yes.

Senator TAFT. I dislike to stop you, but how did they get the money out of Continental Shares and into Foreign Utilities?

Mr. BOLTON-SMITH. Senator, that was done because Continental Shares borrowed money in order to make the $35,000,000 cash pay-

ment to Foreign Utilities, a Canadian company, 26 percent of whose stock was owned by Mr. Eaton and his wife.

Senator TAFT. And did they get stock of Foreign Utilities, Ltd.?

Mr. BOLTON-SMITH. Portfolio securities of Foreign Utilities were transferred.

Senator TAFT. Then they took over the whole company?

Mr. BOLTON-SMITH. That is right, practically speaking, so far as its portfolio is concerned. Then Foreign Utilities paid off its debt to Otis & Co. and deposited $21,000,000 in addition, a part of which was used to pay for the $8,000,000 of securities which Otis & Co. sold to Foreign Utilities to include in the sale to Continental Shares.

Senator TAFT. I came into the committee room a little late and missed that part of it.

Senator HUGHES. Do I understand that during that time the company had an independent board of directors?

Mr. BOLTON-SMITH. It had an independent board, but its management was completely dominated by Mr. Eaton and Otis & Co.; and the management would carry out transactions, which would be ratified in the usual course by the board.

Senator HUGHES. Then where does that leave the argument we have heard that an independent board of directors would be a safeguard; I mean if a management can spring up under it that can control the situation and do these various things?

Mr. BOLTON-SMITH. Senator, it would be a safeguard, but in this case it was not a sufficient safeguard because Mr. Eaton had 15 percent of the stock of the investment company, which was the largest block, and that probably gave him working control. It may very well have been that the majority of the board of directors, which so far as we can discover on paper was independent of Otis & Co., was sympathetic in its ideas with Eaton and Otis & Co. And I might explain that later on, in the Youngstown-Bethlehem merger fight, a majority of the board of directors sided with Mr. Eaton in that fight, indicating that their sympathies were very closely united; but they had no membership in the partnership of Otis & Co.

Senator HUGHES. All right.

Mr. BOLTON-SMITH. Continuing with Mr. Burwell's testimony, he was asked this question, or I should say, he was asked these questions and gave these answers:

> Question. That is, it was the borrowing of this $35,000,000 that put Continental Shares into trouble, isn't that right?
>
> Answer. Exactly so, with the decline in the market, of course, that is understood.
>
> Question. And even with the declining market, if Continental Shares had not had these large bank loans, it would have been able to survive the depression, isn't that right?
>
> Answer. If it had no loans, obviously there would have been no question about it.

Continental's losses as of the beginning of the receivership were about $97,900,000——

Senator TAFT (interposing). Let me ask you a question right there: Would the common stock have been wiped out anyway? Except for the loan would the preferred stock have absorbed all the assets?

Mr. BOLTON-SMITH. I think the rise in the stock market since the depth of the depression, when the bank loans were foreclosed, would probably have been sufficient to give the common stock an equity again. But they were wiped out in June of 1933.

Senator TAFT. Apart from the loan there was preferred stock and it was worth less than par, is that it?

Mr. BOLTON-SMITH. I have not calculated that, Senator, but I would not be surprised. That is, it was the drop in the market price of the portfolio, most of which was pledged for those bank loans, that put the bank loans under water and necessitated their being foreclosed, from the point of view of the banks. But if there had been no bank loans; that is, if there had not been in effect a margin account, the company would not have been sold out, and when the market rose again the preferred- and common-stock holders would still have had an interest in its portfolio of securities.

Senator TAFT. What I was talking about was this: Under this bill as I remember it the preferred-stock holders could have wiped out the common-stock holders had they had at that time the power given under this bill.

Mr. BOLTON-SMITH. I believe that a diversified investment company is to have only one kind of security outstanding; and then there are other types which might have the preferred.

Senator TAFT. This company was not of the diversified type, if I remember correctly.

Mr. BOLTON-SMITH. Senator, it was organized to invest in special situations where businessmen thought they could make profits and Mr. Eaton could carry out his plans for those companies.

Senator TAFT. That is what I say, it was not one of the diversified investment companies such as are referred to here in this bill.

Mr. BOLTON-SMITH. And it is interesting to note that in the prospectus sent to a small group of businessmen in connection with the first issuance of securities, all that was pointed out. But in the subsequent prospectus, sent to the general public when the stock was widely distributed, that was left out and it was said to be in the nature of an investment company or savings bank.

Senator TAFT. All right.

Mr. BOLTON-SMITH. Continental Shares' losses as of the beginning of the receivership, June 22, 1933, were about $97,900,000 out of the total capital raised by the sale of stock of about $111,000,000.

In 1930 Continental Shares organized a subsidiary called Continental Allied to trade in the stock of its parent, Continental Shares. By the middle of the year this subsidiary had lost $412,000, and by the end of the year over $600,000, trying to support the market price of the stock of Continental Shares, and this loss was borne, of course, by Continental Shares.

On May 22, 1930, Mr. Rex P. Arthur, the Denver partner of Otis & Co., wrote to Mr. Eberstadt, the New York partner, urging that more money be poured into a more aggressive support of the stock of Continental Shares, and stating as a reason for this contention, the following:

> As I see Continental Shares, this company is not only the most important financial vehicle which Cyrus Eaton has at his command, but is potentially a tremendous business incubator for us as bankers.

Failing to support more aggressively the falling market for the stock was described as

> the most perfect example of killing the goose that laid the golden egg that has ever come to my attention.

If the committee had the time I would read the entire letter so that all of this could appear in its context; otherwise, I will just cite a few quotations from it. It is two pages long. I think it is all interesting if you would like to hear it.

Senator HUGHES (presiding). Does any member of the committee want to hear it?

Senator TAFT. It will doubtless be in the record. I suppose it shows that those people were using this company for their own banking business?

Mr. BOLTON-SMITH. I think so. I will mention one additional quotation——

Senator TAFT (interposing). That was a letter from the Denver partner of Otis & Co., you say?

Mr. BOLTON-SMITH. Yes, to the New York partner of Otis & Co.

Senator TAFT. All right.

Mr. BOLTON-SMITH. Now, another quotation:

> To remedy this situation: First, the market should be placed entirely in the hands of one operator. I don't think the streets of New York need to be combed to find someone talented enough to handle this market, but whoever the operator is he should stay in New York and be given a free hand.
>
> Second, the popgun idea should be definitely abandoned and heavy artillery brought on. The Allied Corporation should authorize the buying of as much as 10 percent of the outstanding capitalization at current levels.

They lost $600,000 in supporting the market, but his idea was that more money should be poured into an aggressive support of the market. At another place in the letter reference is made to gradually working the market upward, and——

Senator TAFT (interposing). Do you know whether the market was below the asset value at the time?

Mr. BOLTON-SMITH. According to the Denver partner it was somewhat below asset value. The market was about 32 and the asset value was a dollar or so higher than that according to Mr. Arthur's letter.

Senator TAFT. Was the loss to the company, which is the reverse of the situation here, meaning that the loss to the company was to the benefit of the stockholders who were bought out?

Mr. BOLTON-SMITH. To the benefit of those who were bought out, but a loss to those who stayed in.

Senator TAFT. It is the reverse of the situation we had before us yesterday.

Mr. BOLTON-SMITH. I will quote another paragraph from the letter:

> Stabilizing the share at a fair value is highly important not only for the reason that we wish to keep our stockholders but from a future financing standpoint. If the stock is stabilized at 40 I believe you will agree that in a rising market it would be easier to take it to 60 than if we start at 20 and attempt to take it to 50. On an offering of rights, one for 4, a difference of 10 points in the market would mean $6,000,000 to the company.

Senator TAFT. The whole letter will be in our record, won't it?

Mr. BOLTON-SMITH. Yes, sir. The $412,000 trading loss was specifically shown in the draft of audit report submitted by Ernst & Ernst for June 30, 1930. However, the treasurer of Continental Shares had written a letter dated July 21, 1930, to Mr. Eberstadt, the New York partner of Otis & Co., among other things saying:

> Mr. Eaton has suggested that we obtain your opinion on the enclosed balance sheet and account sheets as at June 30, 1930. There are one or two points in

connection with this balance sheet that we would like to get your specific opinion on before endeavoring to have the auditors alter them our way.

I will skip the first point and get to the second, which relates to losses:

> Second, income and expense account: Neither Mr. Burwell (who was the president of the company, that is, of Continental Shares) nor myself is at all satisfied with this, insofar as we believe that it would not be any particular breach from accounting principles if the four hundred and twelve thousand-odd dollars representing the loss in Continental Allied and the $2,052,000, the written down total treasury stocks, were combined by way of a reduction under the caption "Profit on Sales of Securities," so that there would be only one heading here, representing approximately $15,700,000.

Mr. Eberstadt approved, and the treasurer and president of Continental Shares induced the auditors not to show the trading losses in the report but to bury them among the profits on other transactions. As a result the fact that Continental had lost $412,000 supporting its own stock, was concealed. By the end of the year the loss had increased to over $600,000, and this was similarly concealed in the annual report.

Although the majority of Continental's Board was supposedly independent, most of the securities business of Continental Shares, Inc., was handled by Mr. Eaton's and Mr. Eberstadt's brokerage firm, Otis & Co.

Continental Shares purchased $139,000,000 of securities, in lots of over $100,000 each, of which $104,000,000 were bought from or through Otis & Co.

I might explain that I did not go into transactions in less than $100,000 lots because of the amount of detail involved, but the indications are that they follow the same trend as the larger lots.

Continental Shares issued about $113,600,000 of stocks. Otis & Co. underwrote those which were underwritten, and received therefor commissions of $2,654,000.

Otis & Co. also acted directly or indirectly as manager of all of the syndicates in which Continental Shares participated or from which it bought securities.

Continental Shares had acquired such large blocks of companies in key industries that it had a controlling or strongly influential position with regard to their policies. None of its money was used for new enterprises. Along with other Eaton investment trusts and interests, it was used by Mr. Eaton to help him, for instance, bring about the merger of predecessor companies into Republic Steel Corporation, and also to support his successful fight to prevent the merger of Youngstown Sheet & Tube Corporation with Bethlehem Steel Corporation.

In connection with the Youngstown fight, Continental Shares' holdings of Youngstown stock were substantially increased. Continental was allocated about 25 percent of the legal expense, and after the proxy fight took over from Mr. Eaton's Foreign Utilities over 45,000 shares more, Continental realizing a loss of over $4,300,000.

Senator Taft. What percentage of Foreign Utilities, Ltd., did you say Mr. Eaton owned?

Mr. Bolton-Smith. Twenty-six percent.

Senator Taft. He and his wife together do you mean?

Mr. Bolton-Smith. Yes, sir.

Senator Taft. Who owned the rest of that company?

Mr. Bolton-Smith. He did not disclose that at the hearings. He said there were some Canadian businessmen that were close to him who held the other stock.

Senator Taft. I take it it was all closely held stock, that it was not on the market.

Mr. Bolton-Smith. That is right.

Senator Taft. None of it was owned by Continental Shares until this merger you speak about.

Mr. Bolton-Smith. None of the stock issued by Foreign Utilities was ever owned by Continental Shares, but portfolio securities that this private Canadian investment company had owned were purchased by Continental Shares.

Senator Taft. All right.

Mr. Bolton-Smith. Although Mr. Eaton's and Otis & Co.'s other interests were large, it is undoubtedly true that the key holdings by Continental Shares aided Otis & Co. in obtaining underwriting business. It is not surprising to note, for instance, that the two largest issues underwritten by Otis & Co. in 1929 were issues of securities of companies in whose stock Continental Shares held substantial positions.

I believe one can see from this brief summary how the partners of Otis & Co. were able, through their dominating position in the management of Continental Shares, and in spite of the independent majority on the board of directors, to use that investment trust to draw business to their brokerage and underwriting firm, advancing its interests in various ways, and, finally, to meet a crisis in the business of Otis & Co. by using money which Continental Shares had borrowed and was never able to repay.

Mr. Chairman, the statements in this paper from which I have been reading are supported by footnotes, and for that reason I should like permission to file a copy of this statement to be included in the evidence.

Senator Hughes (presiding). Hand a copy to the committee reporter and he will make it a part of our record.

Mr. Bolton-Smith. Including the letter?

Senator Hughes. Yes. We understood the letter was to go in.

Mr. Bolton-Smith. Any questions?

Senator Hughes (presiding). Any further questions by the members of the subcommittee?

Senator Taft. I have no more.

Senator Townsend. I believe not.

(The statement is as follows:)

Statement of Carlile Bolton-Smith

Witnesses have expressed the opinion that if the bill requires that a majority of the board of an investment trust be independent, there is no need of further restricting the membership of the board.[1]

It may throw light on these statements to tell you something of an investment trust, a majority of whose directors were independent of the firm which sponsored it.[2] The facts I shall give you were brought out in a public hearing which I conducted before a trial examiner of the Securities and Exchange Commission as

[1] "Verbatim record of the hearings of Senate Banking and Currency Committee, on the investment-trust bill (S. 3580), Thursday, April 18, 1940," published by the Bureau of National Affairs, Inc., Index Nos. 440–450.

[2] Securities and Exchange Commission file 35–106, Commission's exhibit 3250. Board of Continental Shares: Cyrus S. Eaton, partner, Otis & Co.; W. Russell Burwell, member, Eaton's family; Richard Inglis, partner, Otis & Co.; F. H. Hobson, vice president of Cleveland Trust Co.; Philip Wick, Wick & Co.; R. V. Mitchell, R. V. Mitchell & Co.; David Ingalls, of Squire, Sanders & Dempsey. (Tolless, Hogsett, Ginn & Morley were counsel.)

part of the investment-trust study. The witnesses were men connected with the investment trust and its sponsor.

Otis & Co. was a partnership engaged in the brokerage and underwriting business with headquarters in Cleveland, Ohio.[3]

Mr. Cyrus Eaton had a 40-percent interest in the partnership and was its dominant partner.[4]

In 1926, Mr. Eaton and Otis & Co. organized an investment trust called Continental Shares, Inc.[5] Mr. Eaton acquired 15 percent of the voting stock of this investment trust.[6] In addition to Mr. Eaton, another partner of Otis & Co.[7] and a member of Mr. Eaton's family [8] became members of the board of seven directors of Continental Shares, Inc.;[9] and, although the majority of the board were independent of Mr. Eaton and his firm,[10] Mr. Eaton became chairman of the board. His relative became president. Together they could control the executive committee. And Mr. Eaton was able to control the investment trust, with results beneficial to himself and Otis & Co.[11]

It should be added that Mr. Eaton controlled 26 percent of the stock of Foreign Utilities, Ltd., a private Canadian investment company.[12]

Continental Shares had raised $111,000,000 mostly from the public,[13] had bought heavily in special situations in order to influence policies in large key companies and by October 9, 1930, had been able to pay off almost all of its bank loans.[14]

For some time there had been talk in the Street about Otis & Co. and on October 10, 1930, Otis & Co. had about $11,500,000 of its call loans called by New York banks.[15]

About October 10, 1930, Continental Shares, Inc., agreed to purchase most of the portfolio of Mr. Eaton's Canadian company at a valuation of about $57,000,000, of which $35,000,000 was to be paid in cash and the balance in stock of Continental Shares, Inc.[16] In order to finance this cash payment,[17] Continental Shares, Inc., borrowed $30,000,000 from the Chase National Bank in New York and $5,000,000 from the Union Trust Co. in Cleveland, Ohio,[18] pledging securities as collateral.[19]

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[3] Id. Commission's exhibit 3249.
[4] Id. at 21795.
[5] Id. at pp. 21070, 21072.
[6] Id. Commission's exhibit 3250.
[7] Richard Inglis.
[8] W. R. Burwell, freshman dean at Brown University (Id. at 21071), whose father-in-law was a brother of Cyrus Eaton's father (Id. at 21070).
[9] Id. Commission's exhibit 3259.
[10] Id. Commission's exhibits 3250, 3259, and 3315.
[11] Id.
[12] Id. at 21761.
[13] Id. Commission's exhibit 3256, Id. at 21125, 21733–21735. At the end of 1926 the company had about $4,900,000 of gross assets and about $2,400,000 of net assets. By the end of 1930 the gross assets had risen to approximately $156,500,000, the net assets to approximately $106,850,000. By June 22, 1933, the date of the receivership of the company, the gross assets had dropped to about $16,670,000 and the net assets to $6,456,381 (id. at 21130).
[14] Id. Commission's exhibit 3285. It was enabled to pay off these bank loans as a result of the final cash payment on a large sale of securities to Samuel Insull (id. Commission's exhibit 3339).
[15] Id. at 21311 and Commission's exhibit 3302, memorandum dated Oct. 10, 1930, to Mr. Wiggin, then president of Chase National Bank, from Sherrill Smith, a vice president, reading, inter alia, as follows:
"Re: Otis & Company,
Continental Shares:

"* * * In all probability some of this loan at least, maybe in temporary form, will be taken tomorrow, because of the following:

"*Otis & Co.*—There has been considerable conversation about the firm for some time past; more of it today when they had $11,500,000 of loans called. Morgan's, First National, Guaranty, and ourselves agreed to take these up. Eberstadt says they already have $7,500,000 cash on the way for partial payment. He says the firm this morning conservatively had capital of $20,000,000, probably more, that they are absolutely solvent. Their total loans were probably $120,000,000, all properly secured, but of course he is uneasy if continual calling like there was today continues. He says the $30,000,000 loan will clean up their biggest debit account which is Foreign Shares or Foreign Securities Co. They have been buying utility securities and owing Otis. The proceeds of our loan to Continental Shares will go to Foreign Shares and from them to Otis. Eberstadt says he is satisfied that they have no other debit balances which are large enough to cause them any uneasiness. He says the members of the firm altogether don't owe the firm more than $4,000,000 all properly secured. He don't think there is anything in their debts outside to cause any concern. In addition he is satisfied the principal partners have very substantial net worth outside the firm. I think he estimated this conservatively at $25,000,000. He is very emphatic there is no internal situation or buying in of their own shares which is a problem. He says that of course in their customers' collateral are large amounts of the stocks of companies they have bought into but they are properly margined and he feels sufficiently diversified with no concentration in any one of such size as to cause undue concern."
[16] Id. Commission's exhibits 3287 and 3318–A. 1,040,000 shares. Because Foreign Utilities, Ltd., did not have sufficient cash to release certain of its portfolio securities from pledge, Continental Shares, Inc., agreed on January 21, 1931, to increase its cash payment to $42,600,000; but because the securities had fallen on the market the total purchase price was reduced to $45,400,000, the difference of $2,800,000 being paid in 280,000 shares of stock of Continental Shares, Inc. (Id. at 21253–21254 and Commission's exhibit 3296).
[17] Id. at 21781, 21259.
[18] Ibid.
[19] Id. Commission's exhibits 3343, 3306, 3308–3309 and 3292–A.

It was Mr. Eberstadt, the New York partner of Otis & Co., who negotiated this loan of $30,000,000 from the Chase Bank to Continental Shares, Inc.[20]

By the night of October 13, 1930, the situation with respect to Otis & Co. had reached such a pass that at a meeting between members of the board of governors of the New York Stock Exchange and representatives of Otis & Co., including Mr. Eberstadt, it was made clear that the New York Stock Exchange would not permit Otis & Co. to open for business the next day unless Otis & Co. raised $12,000,000 of new capital.[21] It is interesting to note that at this time the books of Otis & Co. show that Foreign Utilities, Ltd., owed it about $12,000,000.[22]

By the next day, October 14, 1930, the $35,000,000 which Continental Shares, Inc., had borrowed from banks had been paid to Foreign Utilities, Ltd.;[23] Foreign Utilities had paid to Otis & Co. about $33,000,000 which Otis & Co. used to pay off bank loans.[24] Of this sum $12,000,000 represented capital contributed in the name of Mr. Cyrus Eaton which he borrowed from Foreign Utilities, Ltd., for 8 percent, plus a share in his profits.[25] In this way Otis & Co. met the requirement of the New York Stock Exchange that it raise $12,000,000 of new capital, and Continental Shares, Inc., was caused to pledge portfolio securities to borrow the money from which this capital came.[26] Foreign Utilities, Ltd., had paid its $12,000,000 debt to Otis & Co. and deposited with it a credit balance of about $21,000,000.[27] Otis & Co. had paid about $33,000,000 of its bank loans.

In this way, Otis & Co. was enabled to continue in business.[28]

On the other hand, Continental Shares, Inc., was never able to pay off the $35,000,000 of bank loans,[29] from time to time additional portions of its portfolio were pledged to secure these loans [30] and, in June 1933 the Chase foreclosed its loan, selling at auction the major portion of Continental Shares' portfolio [31] so that when Continental Shares went into receivership its portfolio was carried at only $16,500,000 gross and $6,500,000 net.[32]

Although Mr. Eaton claims that the simultaneousness of these transactions was only "a striking coincidence" and that 15 months before he had thought of Continental's buying the Foreign Utilities' portfolio,[33] the actual transactions speak for themselves. And over $8,000,000 of the $57,000,000 of securities sold to Continental Shares had just been bought from Otis & Co. by Foreign Utilities, so that Otis & Co. was indirectly selling over $8,000,000 of securities to Continental Shares. Incidentally, Mr. Eaton's Foreign Utilities made a profit of over $3,000,000.[34]

Besides, as reported in the memorandum from Mr. Sherrill Smith to Mr. Wiggin, Mr. Eberstadt told the Chase when arranging for the $30,000,000 loan to Continental Shares, Inc.:

"* * * the $30,000,000 loan will clean up their (Otis & Co.'s) biggest debit account which is Foreign Shares or Foreign Securities Co. (meaning Foreign Utilities, Ltd.). They have been buying utility securities and owing Otis. The proceeds of our loan to Continental Shares will go to Foreign Shares and from them to Otis. Eberstadt says he is satisfied that they have no *other* debit balances which are large enough to cause them any uneasiness." [35]

[20] Id. Commission's exhibit 3302.
[21] Id. at 21757-21761, cf. 21755-21756. Hearings before the Senate Committee on Banking and Currency 72d Cong., 1st sess., on Stock Exchange Practices, pp. 969-970.
[22] Id. Commission's exhibit 3312.
[23] Id. Commission's exhibits 3291 and 3292.
[24] Id. Commission's exhibit 3297.
[25] Id. at 21794-21795.
[26] Also see infra.
[27] Id. Commission's exhibit 3312.
[28] Later, this partnership sold its brokerage business and commenced a gradual liquidation of its other business under the supervision of Mr. Eaton. A corporation by the same name was formed which is now engaged in the underwriting business and, although Mr. Eaton does not appear as an officer or director, he is connected with it and does "special work" for it. Id. at 21263-21265. See also Securities and Exchange Commission files 43-270, re Consumers Power Co., testimony of William R. Daley, December 4, 1939, at Tr. pp. 7-8.
[29] Id. Commission's exhibits 3285, 3305, 3311, and 3266.
[30] Id. Commission's exhibit 3305.
[31] Id. Commission's exhibit 3311.
[32] Id. Commission's exhibits 3257, 3258, 3266.
[33] Id. at 21787.
[34] Id. Commission's exhibit 3312 and at 21772.
[35] Italic added. Id. Commission's exhibit 3302.

Speaking of this same loan to Continental, another Chase memorandum said:
"I really think we are doing Otis & Co. a big service. * * *"[36]

And yet the majority of Continental's board of directors was independent.

The effect of this sale of securities to the investment company, which had to borrow the money to pay for them, was responsible for the receivership of the investment company. W. R. Burwell, former president of the investment company, testified:[37]

"Q. And it was the failure of Continental shares to pay off the $30,000,000 loan from the Chase Bank and the loan of $5,000,000 from Union Trust Co. that resulted in the foreclosure on Continental's collateral in June, 1933, isn't that right?

"A. Yes.

"Q. So that if Continental shares had not borrowed that $35,000,000 from the banks in October 1930, it would have had no difficulty in retaining its portfolio throughout the depression, isn't that right?

"A. That is quite true, yes.

"Q. That is, it was the borrowing of this $35,000,000 that put Continental shares into trouble, isn't that right?

"A. Exactly so, with the decline in the market, of course, that is understood.

"Q. And even with the declining market, if Continental shares had not had these large bank loans, it would have been able to survive the depression, isn't that right?

"A. If it had no loans, obviously there would have been no question about it."

Continental's losses as of the beginning of the receivership were about $97,900,000;[38] capital raised by sale of stock had been about $111,000,000.

Continental Shares, in 1930, organized a subsidiary (Continental Allied) to trade in the stock of its parent, Continental Shares.[39] By middle of the year this subsidiary had lost $412,000 [40] and by the end of the year over $600,000,[41] trying to support the market price of Continental Shares stock [42] and this loss was borne, of course, by Continental Shares.[43]

Losses realized on sale of securities in portfolio (net)	$54,904,118
Shrinkage in assets upon revaluation by receiver	43,021,261
Total	97,925,379

On May 22, 1930, Mr. Rex P. Arthur, the Denver partner of Otis & Co.,[44] wrote to Mr. Eberstadt, the New York partner, urging that more money be poured into a more aggressive support of the stock of Continental Shares and stating as a reason for this contention the following:[45]

"As I see Continental Shares, this company is not only the most important financial vehicle which Cyrus Eaton has at his command but is potentially a tremendous business incubator for us as bankers."

Failing to support more aggressively the falling market for the stock was described as "the most perfect example of killing the goose that laid the golden egg that has ever come to my attention."

The $412,000 trading loss was specifically shown in the draft of audit report submitted by Ernst & Ernst for June 30, 1930. However, the treasurer of Continental Shares had written a letter dated July 21, 1930, to Mr. Eberstadt saying, among other things:[46]

"Mr. Eaton has suggested that we obtain your opinion on the enclosed balance sheet and account sheets as at June 30, 1930. There are one or two points in

[36] Id., Commission's exhibit 3300. An interoffice memorandum of the Chase National Bank dated Oct. 9, 1930, from Mr. James Bruce to Mr. Clarkson concludes a discussion of the proposed loan as follows:

"I really think we are doing Otis & Co. a big service, chiefly because they are not securities which they could put up for their loans but would have to make special loans on them and I believe the Cleveland banks are pretty well loaded up with loans on Otis' enterprises and I think the New York banks are probably a little skeptical. For this reason they should certainly pay a substantial rate on a loan of this kind, and I do not think we should soften up Mr. Wiggin's proposition in any way."

[37] Id. at 21326.

[38] Id. Commission's exhibit 3258.

[39] Id. Commission's exhibit 3327.

[40] Id. Commission's exhibit 3324, 3326.

[41] Id. at 21456.

[42] Id. at 21456–21457.

[43] Id. at 21477 and Commission's exhibits 3328, 3263.

[44] Id. at 21450. See also Securities and Exchange Commission file 8-1 re Otis & Co. (Colorado).

[45] Id. commission exhibit 3322.

[46] Id. commission exhibit 3324.

connection with this balance sheet that we would like to get your specific opinion on before endeavoring to have the auditors alter them our way.

* * * * * * *

"Second, income and expense account: Neither Mr. Burwell nor myself is at all satisfied with this, insofar as we believe that it would not be any particular breach from accounting principals if the four-hundred-and-twelve-thousand-odd dollars representing the loss in Continental Allied and the $2,052,000, the written down total treasury stocks, were combined by way of a reduction under the caption 'Profit on Sales of Securities', so that there would be only one heading here representing approximately $15,700,000."

Mr. Eberstadt approved and the treasurer and president of Continental Shares induced the auditors *not* to show the trading losses in the report but to bury them among profits on other transactions.[47] As a result, the fact that Continental had lost $412,000 supporting its own stock was concealed. By the end of the year, the loss had increased to over $600,000 [48] and this was similarly concealed in the annual report.[49]

Although the majority of Continental's Board was independent, most of the securities business of Continental Shares, Inc., was handled by Mr. Eaton's and Mr. Eberstadt's brokerage firm, Otis & Co. Continental Shares purchased $139,000,000 of securities in lots of over $100,000 each, of which $104,000,000 were bought from or through Otis & Co.[50]

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In connection with the Youngstown fight, Continental Shares' holdings of Youngstown stock were substantially increased, Continental was allocated about 25 percent of the legal expense and after the proxy fight took over from Mr. Eaton's Foreign Utilities over 45,000 shares more, Continental realizing a loss of over $4,300,000.[54]

Although Mr. Eaton's and Otis & Co.'s other interests were large, it is undoubtedly true that the key holdings by Continental Shares aided Otis & Co. in obtaining underwriting business. It is not surprising to note, for instance, that the two largest issues underwritten by Otis & Co. in 1929 were issues of securities of companies in whose stock Continental Shares held substantial positions.[55]

You can see from this brief summary how the partners of Otis & Co. were able, through their dominating position in the management of Continental Shares and in spite of the independent majority on the board of directors, to use that investment trust to draw business to their brokerage and underwriting firm, advancing its interests in various ways and, finally, to meet a crisis in the business of Otis & Co. by using money which Continental Shares had borrowed and was never able to repay.

CARLILE BOLTON-SMITH.

APRIL 26, 1940.

[47] Id. at 21460, Commission's exhibit 3325 and exhibit B.
[48] Id. at 21456.
[49] Id. Commission's exhibits 3263 and 3388.
[50] Id. at 21477–21478. On the basis of $100,000 lots and excluding exchanges and the $57,000,000 purchase from Foreign Utilities (id. at 21480).
[51] Id. Commission's exhibit 3256.
[52] Id. Commission's exhibits 3340, 3280, 3313, etc. Analysis of Continental Shares, Inc., p 46.
[53] Id. generally.
[54] Id., committee exhibits 3262, 3287A, 3296, 3318A, exhibit B. Analysis, pp. 121, 93, 116, 138–151.
[55] According to American underwriting houses and their issues, Otis & Co. underwrote, inter alia, the following:

May 1929: 500,000 shares the United Light & Power Co. $6 cumulative convertible first preferred stock (no par). Otis & Co. led the list of underwriters.

October 1929: $60,000,000 the Firestone Tire & Rubber Co. 6 percent cumulative preferred stock A (par $100) with stock warrants. Otis & Co. led the list of underwriters.

Continental Shares, Inc., had substantial common-stock interests in these companies (id., committee exhibit 3262) and in October 1930 took over the even larger blocks of United Light & Power held by Foreign Utilities, Ltd., and Otis & Co. (supra and id., committee exhibit 3296).

Docket No. —. Commission's exhibit No. 3322. In the matter of Continental Shares, Inc.; January 26, 1938

OTIS & CO.,
Denver, May 22, 1930.

MR. FERDINAND EBERSTADT,
Otis & Co., New York City.

DEAR FERD: On several occasions I have been at the point of writing you exactly what I think of the Continental Shares situation. Your telegram of yesterday decided me.

First, let me assure you we are not overestimating the seriousness of the local situation. When Continental Shares breaks below 30 we are in imminent danger of having to sell out a large number of our best accounts; not joyriders and weak speculators but friends of ours who bought this stock in the beginning and all the way up. Naturally, if we start this selling the market will go lower which will in turn force further liquidation. Granted, that this predicament is most serious to the Denver office I still feel that it is not our predicament alone, but one which in a much larger sense affects the entire firm and the firm's future. When I tell you that the morale of the entire selling organization of Otis & Co. is shot to pieces just over this Continental Shares matter alone, I'm not guessing as I know the feeling of practically every office in the circuit.

As I see Continental Shares, this company is not only the most important financial vehicle which Cyrus Eaton has at his command but is potentially a tremendous business incubator for us as bankers. For the past 9 months this stock has been continuously and persistently working down. With all due allowance for the condition of the general market, it is perfectly clear that the handling of this particular market has been extremely bad. Sporadic attempts have been made from time to time to give support but there has been no continuity to the effort and at no time has the market been aggressively worked on the upside. Negative support only, that is, buying orders under the market is just wasted effort and money since any stock left to flounder will inevitably work down and through any support level.

I don't think the above assertion is open to argument. Continental Shares is worth, roughly, $10,000,000 more than it was on December 31 and the market for the shares is 15 points lower. To cite an instance, several thousand shares of stock were taken at 30 recently in one day. Following that and ironically enough, after the pressure was removed from the list and stocks were climbing, Continental Shares was left to kick about for itself as best it could so that on one day, May 19, the market broke three-quarters of a point on a sale of 100 shares and opened the next morning seven-eighths of a point down on another 100 shares. In the past week, since the market broke 32, there has at no time been any real pressure on the market, the sales not running much more than 2,000 shares a day, yet the stock is down 4 points. This situation strikes me as a serious one, a costly one, not only in its effect on our own business but in that the growth of Continental Shares is absolutely cut off while the stock acts in such a manner.

Stabilizing the share at a fair value is highly important not only for the reason that we wish to keep our stockholders but from a future financing standpoint. If the stock is stabilized at 40 I believe you will agree that in a rising market it would be easier to take it to 60 than if we start at 20 and attempt to take it to 50. On an offering of rights, 1 for 4, a difference of 10 points in the market would mean $6,000,000 to the company. To remedy this situation: First, the market should be placed entirely in the hands of one operator. I don't think the streets of New York need to be combed to find someone talented enough to handle this market but whoever the operator is he should stay in New York and be given a free hand. Second, the popgun idea should be definitely abandoned and heavy artillery brought on. The Allied Corporation should authorize the buying of as much as 10 percent of the outstanding capitalization at current levels.

No better investment could be made if this stock could be acquired to average under 35. As a matter of fact, I do not suppose that over 75,000 shares could be bought at such a price. If the company is not in funds why not sell some of their blocks of securities which do not have a key position in the picture and with the proceeds buy Continental Shares. Third, pave the way for an increase in dividend. Whether this increase is in stock or cash makes little difference. Personally, I would favor the former. We must accept human nature as it is and while in theory an investor should be willing to patiently await the outcome of large plans we must recognize the fact that investors will not keep a stock which has neither market action nor dividend to recommend it.

The liquidating value of Continental Shares is, I understand, about 36, or, in other words, the market value is approximately 15 percent below the liquidating value. The purchase of the shares on the open market obviously affords us an arbitrage of great value. When the general market has an upturn these shares could easily be distributed by our retail organization and outside dealers.* It is just a cinch, by the way, that money and effort spent on building up a dealer-following is thrown away until such time as the share is properly sponsored. Other corporations who need capital constantly are perfectly alive to this and we must come to it. Our own retail clientele alone could supply us with millions of dollars each year. At present, instead of doing this, we are letting them and their money be booted right to Hell or into the hands of our competitors. It is the most perfect example of killing the goose that laid the golden egg that has ever come to my attention.

With best regards, I am

Most sincerely yours,

REX ARTHUR.

Senator HUGHES (presiding). Who will be the next witness?

Mr. SCHENKER. Senator, we should like to have you hear from the Commission's chief accountant at this point, Mr. Werntz.

Senator HUGHES. Very well; please come forward, Mr. Werntz.

STATEMENT OF WILLIAM W. WERNTZ, CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. WERNTZ. Mr. Chairman, my name is William W. Werntz. I have been chief accountant of the Commission for the past 2 years.

I have prepared a statement which outlines in some detail certain accounting practices and abuses which we have seen in the investment trusts which have filed with us under the Securities Act and the Exchange Act. In order to save time, I should like, rather, just to mention briefly some of those now, and then submit the paper for the record, if you agree to that.

Senator HUGHES (presiding). Very well.

Mr. WERNTZ. I should like to make clear first that I did not participate in the investment-trust study, although I have considered the reports and have offered some comments upon certain of them. I gave particular attention to the United Founders report and to the general report on accounting practices.

The statement is frequently made that investment-trust accounting can be made very simple. Unfortunately, the principal difficulty in considering investment trusts is that there are very widely divergent practices as between trusts. Unless you are able to compare the performance record of various trusts, it seems to me that you would have a great deal of difficulty in appraising the relative merits of two companies; and, unless their statements are on substantially the same basis, we have found great difficulty in comparing them.

Now, Senators, let me say that, unlike industrials, the investment trust does not have a great array of complex problems. The problems it does have are, however, very intricate. They center around two or three major points.

First, of course, is the matter of the valuation of the portfolio; second is how you determine whether you have made a profit when you sell it; third is the treatment of your own actions in declaring dividends and in redeeming or selling stock; and last is the question of taking into income noncash receipts; that is, such things as stock dividends and stock rights and the like.

Just to show you the diversity, I should like to cite one example. Take, for instance, this question of determining whether you have made a profit when you sell a security: Suppose you purchased 10,000 shares at $10, and some other time 10,000 shares at $20. When those shares are sold, there are at least three methods of reporting a profit. Many—perhaps the majority—would report it on the basis of average cost, which would be $15 a share, so if they sold 10,000 shares for more than $15 apiece, they would report a profit.

Others, however, would follow the first-in and first-out method; and in my example I assume the first shares were purchased for $10. So if they sold them for $15, they would report $5 a share profit.

Some others would use the specific certificate method. In that procedure they select the certificate they will sell; so at the election of the management they could report a $50,000 profit or a $50,000 loss, or presumably could take some from each and report neither a profit nor a loss.

To my way of thinking, if you have two trusts and one of them does one of those and one does the other, you would have exactly comparable situations and completely different results.

I think it is possible to overcome most of those difficulties by means of agreed-upon rules in the form of uniform classifications.

Of course, the same procedure would have an effect on the way the trust carried its portfolio. If it takes securities out at average cost, then the remaining securities are held at average cost. If it takes them out at specific certificate, the remaining securities would be on a cost basis, figured according to that method, and you would get diverse results.

Possibly by comparing the two factors, namely, the value of the securities kept or the carrying value of them and the profits realized, you can compare the two trusts; but ordinarily that information is not always given. Furthermore, even if it is given, it requires a rather complex compilation, at times, to make a comparison.

Some of the companies even use two methods at the same time. For example, they will carry one block of securities of a particular issue at average cost and use the first-in, first-out method for similar securities that they are trading in from day to day.

The second question—the basis of carrying the portfolio—raises just as many problems. For example, you will find that some companies have written down their portfolios to less than cost, taking the market at some particular date. Thereafter, some of those trusts will report the excess over that written-down figure as profit. Some of them will call it merely recapture of write-offs. When you try to compare that type of company with the company that stuck to the costs or the company that carried its securities at market, you inevitably have difficulties.

Even if the information is all available in one form or another or by reference to market quotations, it makes a rather difficult computation to get the two on the same basis.

Senator TAFT. You are suggesting that uniform methods of accounting should be prescribed? Is that the point?

Mr. WERNTZ. That is correct. I wanted to point out one or two illustrations of that.

Senator TAFT. Yes.

Mr. WERNTZ. The stockholders' reports which we have examined in connection with our work reflect all of these differences: That is,

they do not keep their books differently than they report in their annual statements to stockholders.

Senator Taft. Even the Government bureaus have a pretty hard time agreeing, do they not, on which method to follow?

Mr. Werntz. That is true in some fields.

Senator Taft. Does not the income tax require one thing and somebody else require another?

Mr. Werntz. That is correct. However, of course, those are for different purposes.

Senator Taft. Well, it is inconvenient to keep your books two or three different ways, for two or three different purposes.

Mr. Werntz. That is perfectly correct; and I think it would be very fine if we could get them together. We have suggested at various times the possibility of avoiding some of those difficulties, but have not been able to get very far.

Coming to the specific sections of the bill, I notice some question raised as to the inclusion of the words "cost-accounting procedures" in the uniform accounting section. You may recall that in two other sections of the bill we are given power to require that services be rendered by certain subsidiaries at cost, and also certain controls over the sales load. The purpose of that particular phrase, which is rather strange for an investment trust, is to be sure that in exercising those powers we can require the information in the accounts which will enable us to tell whether they are actually rendering service at cost and to tell what the elements of the sales load are.

One other section of the bill has some important bearing on accounting, and that is the question of dividends. The bill as it is now written prescribes mostly disclosure, with some reference to the asset provisions. While it is a little out of my province, I should like to point out just briefly one or two of the difficulties you get into with dividends—possibly as an indication that something more than a disclosure statute is essential.

It seems to me that the question of the propriety of dividends for an investment trust depends very largely on a series of factors: First, the type of trust; that is, whether you have a diversified company or whether you actually have a trading company or a finance company; second, whether you have senior securities or not; and, finally, whether you are one of these open-end trusts making continual sales and repurchases or whether you sell in large blocks as a closed-end company.

If you have a diversified trust, it is hard to see why profits and losses on the sales of securities should affect the divided policy. On the other hand, if your business is trading, it seems to me the dividend policy should be keyed not only to the income from securities but also to the profits and losses on trading and, indeed, to the depreciation of the portfolio that is left over, since that eventually will be reflected in the profit accounts.

In your open-end companies you, in effect, are continually repaying part of the appreciation or depreciation of the portfolio; and for that reason there might very well be differences in the dividend theory—and also, of course, you are paying capital along with the depreciation or appreciation.

One other question that I should like to discuss is the little provision which gives the Commission authority to prescribe the minimum scope of the audit. That is a very difficult question, to my mind. It

is clear to me that you cannot get good audits by writing rules; because they are composed of two things: first is the procedure and second is the alert performance of that procedure—more particularly the invention or selection of tests, after you have seen what you are getting into.

That sort of thing cannot be prescribed by rules, except with respect to a particular audit; and, obviously, you cannot prescribe rules for each audit.

On the other hand, it does seem possible to select some major points which every audit should hit. You would leave to the auditor his most important function, namely, discretion, by making those very skeletonized. In that way it would be up to him to fill in the blanks and make a good audit out of it.

Or you might possibly use a rule which merely required him to perform an audit in accordance with the accepted standards of the profession or—if you did not wish to refer to those—sufficient to present comprehensive and dependable statements.

Senator TAFT. I did not understand that. Are these Government auditors?

Mr. WERNTZ. No, these are private auditors.

Senator TAFT. These are private auditors?

Mr. WERNTZ. Yes. I think the auditor performs a very valuable function; and, to that extent, I think his work should be retained, but I think we need some method of controlling the work.

Those are just the high points; and with your permission I should like to introduce this.

Senator HUGHES (presiding). Yes.

Mr. WERNTZ. First, let me say that I have been chief accountant for the Securities and Exchange Commission since May of 1938. For 6 years prior to coming with the Commission in 1935, I taught accounting, corporation finance, and law at Yale University and the Yale law school.

The basis for my observations with respect to the accounting provisions of the investment trust bill is my work with the Commission primarily as chief accountant. In connection with this work I participated in the drafting of forms for annual reports of investment companies and have handled accounting problems arising with respect to investment trusts under the Securities Act and the Exchange Act. While I have not participated in the investment trust study, except occasionally in an advisory or consulting capacity, I have read a number of the reports and submitted comments with respect to some of them. I have given particular attention to the report on the United Founders group and to the general report on accounting practices which I believe has not yet been published. These two volumes deal primarily with the widespread and serious accounting and auditing problems and abuses which were found to exist in the period covered by the investment trust study. What I should like to do today is to review very briefly for the committee the situation which we have encountered in our recent work with investment trusts under the two securities acts and to comment briefly and in a general way as to the accounting provisions included in the investment trust bill.

In place of the varied problems of the industrial or commercial company, the investment trust is concerned principally with a much

smaller group of accounting problems. These relate to the valuation of its portfolio securities, its treatment and determination of profit and loss upon the disposal of securities, the determination of its income when received in other than cash, and the reflection in its accounts of the corporate action of declaring dividends and selling and redemming its shares. While these accounting problems may be limited in number, they are nevertheless complex. One of the principal difficulties is the question of how to present the results of operations. The investment trust deals largely in marketable securities and is therefore concerned not only with the classical cost concept of accounting but also with a present estimate of value. It is the interrelation of these two values which leads to most of the complex problems which investment trust accounting faces. Like its accounting, the problem of auditing the investment trust is relatively less complex than the problem of auditing an industrial or commercial enterprise. Auditing these companies involves principally a determination that the securities and cash are there, that the securities and cash have been used solely for the purposes of the corporation, and that disposals and acquisitions of securities and income from interest and dividends have been properly accounted for.

Although investment trusts have been relatively numerous since about 1925, so that their accounting problems have been forcefully before the industry and the profession for at least 15 years, there has not as yet appeared a single comprehensive accounting discussion, in the form of a manual or handbook, for example. There have been a number of articles, most of which deal with special phases or with financial problems. None of them has attempted to present a well-developed accounting basis for the investment trust. There has been, I think, a general improvement in accounting methods for investment trusts during the past 10 years, particularly since the enactment of the Securities Act and the Securities Exchange Act. This improvement has worked toward a development of the standards of accounting principles applicable to investment trusts and has also worked toward more disclosure to stockholders and investors of the condition and the results of operation of these trusts. Notwithstanding this improvement, there remain in many fields, as I shall point out later, two or more well-recognized methods which are diametrically opposed to each other. As a result, under the Securities Act and the Exchange Act, which are principally disclosure statutes, we have not felt able to do more than accept any one of the well-recognized methods in a particular field, possibly with the disclosure of the results on some other more common basis in particular cases.

Uniformity of disclosure is particularly important to stockholders and investors with respect to investment trusts. Essentially, the investment trust is selling an investment service which usually is coupled with continued managerial discretion in the type of investments to be made. While this is the common feature of all investment trusts, it does not mean that there are not different types of trusts and that as between these different types of trusts there should not be differences consistent with their inherent purposes and expressed appropriately in their accounting and reporting. Nevertheless, if two investment trusts fall within the same general group, it is extremely important, in my opinion, that their financial statements and the principles upon which those financial statements are based should be

as nearly uniform as is possible, so that stockholders and investors may readily compare the performance of the two trusts. As an example of importance to stockholders, I may cite at this point the difference in result that can be reached in determining the cost of a particular security sold by a given company. If we should assume that a company had purchased a thousand shares of a particular stock at $10 a share and at some other time had purchased a thousand shares at $20 a share, it will be seen that the aggregate cost of the 2,000 shares is $30,000. However, if 1,000 shares of this block are sold at $15, there are at least three bases, and possibly more, upon which investment trusts customarily report the results of the sale to their stockholders. Those trusts employing the average basis would report no profit on the sale since the average cost of the 2,000 shares is $15 per share.

Those trusts which report on the first-in first-out basis would report a profit of $5,000 since the first shares purchased cost $10 each. Those trusts which use the specific certificate method would be in a position to select which of the two certificates they would sell. Should they select the $20 certificates, a loss of $5,000 would be reported, whereas if they selected the $10 certificates a profit of $5,000 would be reported.

The argument is sometimes made that if the sales price in this case reflected the market price then at all times the unrealized depreciation or appreciation on the remaining shares plus the realized profit or loss reported would total the same figure, thus making the method of determining cost with respect to the shares sold immaterial. However, it is my belief that a realized profit or loss is quite a different thing in the average case from an unrealized appreciation or depreciation. By making the sale, the company has changed its investment. The proceeds presumably will be invested in some other security subject to different risks and different conditions. The unrealized depreciation or appreciation on the unsold securities is of course still subject to the risks on the old securities. Moreover, the dividend policies of many trusts depend in part on the amount of profit or loss realized on securities sold. Finally, given an unscrupulous management, there is every opportunity for misleading stockholders, and, so long as several conflicting methods remain in use, accountants are powerless, or at best can only note an exception.

It is frequently argued that disclosure of the methods employed, with the possible inclusion of a statement of results on some other method, is all that is necessary. Mere disclosure, however, in most cases is not sufficient to enable comparison of companies using different methods. Ordinarily the disclosure will not be sufficiently complete to put the two on a comparable basis. Even if the disclosure is sufficient for that purpose, generally, only an expert accountant or analyst will be in a position to make the necessary computations. Furthermore, in reporting the results of the two trusts in the statistical services and in news items, the explanations necessary to make the comparison are rarely carried over, so that what customarily happens is that the results of one trust on one basis are compared with results of another trust on another basis. Some certifying accountants take exception to certain of the above methods of determining cost of portfolio securities sold. Other accountants would take no exception. The reader of the statements, unless he is in a position to appraise the relative desirability of the various methods, is at a loss, in my opinion,

to determine the significance of the certifying accountant's exceptions in such cases.

I feel, therefore, that uniform accounting between trusts of the same class is most desirable. The question is how to obtain this uniformity. In my opinion, it is necessary to have some regulatory body clothed with sufficient authority to study and determine the relative merits of the various conflicting thoughts on the subject and to establish a uniform accounting practice. I do not believe that it is practicable to incorporate such a system into a statute. The classification would be much shorter than would be necessary for many other types of business. Nevertheless, to insure substantial uniformity of results the classification would run at least the length of this statute. If several classifications were necessary, as I believe they are, for varying types of trusts, the incorporation in statutory form would be extremely bulky. Moreover, it would be necessary either to make the statute completely rigid, thus freezing accounting for investment trusts at their present level or at some agreed-upon level, or it would be necessary to leave to someone sufficient discretionary powers to adapt the classification to the course of development in accounting and financial thinking on the subject. To my mind, leaving such discretion in a regulatory body would fall little short of giving that same body power to prescribe a uniform classification after consultation with the industry and the accounting profession.

The accounting sections of this bill, in substance, do no more than give the Commission the power to prescribe classifications of accounts and accounting principles for the various classes of investment trusts and give the Commission sufficient powers to enforce the observance of these classifications. The language of section 31 which outlines the powers delegated with respect to classifications of accounts is in somewhat more detail than is found in many comparable situations. This detail in effect specifies many of the more important types of transactions, control over the recording of which is necessary to a proper presentation of financial statements. One thought occurs to me in connection with subsection (a). The phrase is there used: "Cost accounting procedures." It may seem strange to find such a phrase used in connection with an investment trust. However, I believe that phrase insures implementation of the Commission's powers under section 15 (e) and 22 (c) which permit or require the Commission to forbid a grossly excessive sales load and, in the case of affiliates, to require the rendering of managerial services at cost. I believe that, unless the Commission is in a position to determine or control what the elements of cost are and how they should be computed, it would not be in a position to enforce the observance of those sections by the investment companies affected.

Question may also be raised as to the subparagraph of section 31 which permits the Commission to forbid the keeping of double sets of books. As I view this section, it specifically does not cover the mechanical aspects of bookkeeping; that is, for example, whether you should use machine methods or hand methods; nor does it forbid the keeping of supplemental subclassifications or break-downs necessary or desired by particular companies. What it is meant to do, as I see it, is to prevent an investment trust from keeping its financial records on different and inconsistent bases. While one frequently

hears of a company keeping two or three sets of books for use by different people, in fact what is generally meant is that there are certain classifications or subclassifications which are kept for informational or other special purposes. Normally these records for special purposes are easily and directly reconciled with what might be called the basic books of account. For example, it is not at all unusual to find a series of accounts which record assets at a written-up or written-down amount and which include supplemental records reflecting these same assets at the tax cost to the corporation. The intention of these sections, I believe, is to prevent the keeping of completely separate, unintegrated, or inconsistent sets of records.

I have mentioned previously the importance of uniformity in investment trust accounting when the investment trusts are of comparable types. The principles upon which their financial statements are based and upon which their reports to their stockholders are made should be sufficiently similar so that the reader of the financial statements of different companies will be able to obtain comparable information as to the companies without making a detailed study of the particular methods in use by the particular company and without the necessity of reconciling different methods to a common basis. If financial statements are to be used by substantially similar companies as a means of transmitting information about their condition and operations, they will, I think, fail if a company in recording its history and presenting its results follows methods that are incomparable with the methods employed by other companies. The methods now in use are frequently diametrically opposed even though, as I pointed out before, the number of problems involved is not nearly so great as in the case of industrial and commercial companies. It may be of interest to outline very briefly some of the principal problems which we find in reports filed with us or sent to stockholders by investment trusts at the present time.

I mentioned a while ago the varying methods in use to compute the profit or loss upon disposal of part of a block of securities. In glancing through a handful of annual reports recently issued to stockholders, I found that while the majority employed average cost, nevertheless some of them employed the specific certificate method, some employed the first-in, first-out method, and one at least utilized a replacement cost method.

In addition, cost did not always mean the same thing. A considerable number of companies meant by cost the market price of the securities at some date in the past when a voluntary recapitalization of the company had taken place. In one case at least these write-downs to a lower level had been accomplished by vote of the directors without any approval whatever of the stockholders. No information was included to indicate what the real original cost to these companies had been and, since the dates as of which the market prices were taken were spread over a period of many years, it was impossible to compare the performance of the several trusts. Some of them apparently were fortunate enough to select the point at which market prices were very low, and as a result showed a market value in excess of the previous carrying value. Others still showed a depreciation from that original carrying value. In reporting the results of sales of some of these securities, the terminology was quite varied. Some called them profits, even though the selling price was less than original cost. Others labeled the gains over book values as merely recaptures of

previously written-off amounts. Even in the method of reporting realized profits and losses on securities, differences occurred. Some reflected the realized profits in the income account, others carried the items through to earned surplus, and many of them carried the profits direct to the capital surplus account.

Variations in the method of computing profits and losses, in the methods of displaying the results of sales of securities, and in the dividend policies make for great complexity not only in determining what a particular trust has done during a given period but, more important, in comparing the results of different trusts.

It should also be noted that the method of determining the cost of securities sold has a reflex action on the carrying value of the securities that are left. In the example I mentioned earlier, the securities retained could be shown at $10,000, $15,000, or $20,000, depending on the method used.

If the use of the specific certificate or first-in-first-out method results in the elimination of the high-cost shares of a particular block, the excess of market values over carrying values is increased, or the excess of cost over market decreased. If low-cost securities are taken out by one of these methods, excess of market over cost is lessened or the excess of cost over market increased. To the extent that a dividend policy is keyed to the realization of appreciation, such methods enable the management to allocate profits and dividends to one period as compared to another.

This brings me to the display in the statements of the carrying values of securities. While most of the trusts carry them at cost and show market in a footnote or parenthetical explanation, some carry securities at market, and in a few cases at cost or market, whichever is lower. As pointed out above, many of the trusts have revalued their portfolios in past years, in most cases charging the decline to capital surplus, with the result that cost of the securities still held is not directly original cost but the chance market valuations at the date of the write-down. Thus, cost means market as of a particular date, with subsequent additions at cost, and there is no disclosure of the past performance of the trust. While it may be said that past cost is not of great importance to a person who is buying into an investment trust on the basis of the present market, it must be remembered that the present investor is entrusting his investments to a particular company; and I believe that a record of the past performance of that company is a significant factor in his choice of companies.

Variations also appear in the way in which depreciation of portfolio securities is accounted for. Some trusts provide a reserve charged to capital or to earned surplus to reduce the securities to market. Others carry the securities at market and show the deduction from cost to market as a deduction from earned surplus on the balance sheet or in a statement of surplus. Still others give both cost and market and include a discussion or display of unrealized appreciation and depreciation in some other part of the statement, perhaps coupled with a disclosure of the realized profit or loss during the period, and perhaps further coupled with a statement of the change since the preceding balance sheet.

Instances exist of varying interpretations of what the term "market" means. When there was no recent sale in the market, some have used

the bid price, and some the average of the bid and asked for the day or over a short period. While in the case of active stocks listed on one of the larger exchanges, the difference between bid and asked prices may not be significant, nevertheless many trusts have a large volume of unlisted securities in their portfolios; and the spread between bid and asked price in the over-the-counter market is apt to be large in many cases, with the result that market in effect has no common meaning as between different trusts. Nonmarketable investments are carried sometimes at cost, sometimes at values set by the directors.

Turning to the income account for the moment, a review of recently issued annual reports indicated that some companies include dividends on their portfolio securities when declared, others not until received. While such items in the long run would make little difference perhaps, in either the aggregate income or the income for a particular period, there can easily be situations in which the treatment accorded becomes important. I recall a recent case in which a company took up dividends as income only when they were received in cash. This particular company went through a voluntary reorganization as of, let us say, July 1, writing down its portfolio securities by a very substantial portion of their carrying value, charging the write-off to earned surplus, thus eliminating that account, and charging the balance to capital surplus.

No recognition was given to nearly a million dollars in dividends which had been declared prior to July 1 but which would not be received until after that date. As a result, had the company's policy of accounting for dividends been followed, there would have appeared in the first few days of July a very large credit to income and earned surplus, although in fact these dividends were an asset of the company before the reorganization took place.

Another problem in this field is the question of the treatment of stock rights and stock dividends on portfolio securities. At least four methods are supported by various people. Some believe they should be taken in as received at market, others when received but at some other figure than market; still others believe no recognition should be given at the time of receipt but that if sold the proceeds should be treated as income. Still others believe that the cost of the stock upon which the stock dividends are declared should be spread over all of the stock owned after receiving the dividend or exercising the rights, and the cost of each share reduced accordingly. Then, upon sale of any particular share, the new cost would be compared with the selling price, and the difference treated as profit or loss. Thus, depending on the methods used, all the profit could be shown at once, even if followed later by a loss; or it might be spread over many periods as the securities were sold.

On the expense side of the income statement, different policies are in effect with respect to the amount of break-down given. Some give a particularly well-chosen break-down, although it is not always possible to determine whether the individual items are comparable with the items of other trusts, since many variations in the allocation of expenses may be hidden under the general titles used. Naturally, in appraising the efficiency of a particular trust, the cost of obtaining the investment service in the form of management fees and administrative expenses is a most important item. Yet we find cases in which the management fee is charged directly to surplus, sometimes in con-

junction with other expenses. In other cases we find a break-down which does not disclose the management fee, although this is becoming increasingly rare. In some cases there appears to be no management fee, the manager expecting to receive his remuneration from brokerage fees or from the power which control of capital may give. Many of the better trusts give a clear disclosure in supplementary information of brokerage fees paid, and amounts paid to affiliates. Others do not.

One problem of particular difficulty in connection with the sale of shares by an open-end trust is the question of equalizing the interest of the income shareholders in the distribution account. Quite customarily there is added to the income available for distribution under the dividend policy of the company a pro rata part of the amount paid in by an incoming shareholder, so that when the first dividend is paid he, in effect, receives income on his investment only from the date of entry into the company. This is much the same as the theory upon which evidences of indebtedness are sold at a fixed price plus accrued interest to the date of sale. Yet these equalization credits, as they are called, are sometimes treated as an addition to the profit-and-loss account, in other cases as an adjustment of distribution account, and in still other cases as a credit to capital surplus, the subsequent dividend being sometimes charged entirely against the distribution account.

An even more complex problem arises upon the redemption of shares, and this is one point at which differences in treatment may well be justified between a closed-end company on the one hand and an open-end company on the other, in view of the fact that in the latter case the redemption is more or less obligatory and is required to be made at the market value as of the date of redemption, after certain adjustments. Yet, as between various types of companies we find extremely wide variations in the accounting for such transactions. In some cases at the time of reaemption a pro rata portion of each of the net worth accounts is written off the books; so, if a company has a deficit due to security losses, either realized, or prospective, the amount paid in by the unit holder in excess of the amount received on redemption is treated as a direct offset to the deficit due to the security losses which resulted in the low redemption price. In others, this is treated as a capital surplus credit, the aggregate losses on sales of securities being retained as a cumulative deficit account. If the unit value has appreciated, the excess paid out is sometimes charged to earned surplus, sometimes to realized appreciation on security sales, sometimes merely to capital surplus. These differences make very complex an appraisal of the past results of the management's handling of the funds entrusted to them.

Another question is how to account for wide swings in the price level which result in a very great depression in security prices or possibly a very large appreciation. I mentioned these briefly as restatements of portfolio values above. This situation is not by any means peculiar to investment trusts, although certain of the problems of investment trusts will differ from those of the average industrial company. It seems to me that when a new cost basis is to be established for a particular company, through write-down of its securities, it is a matter which requires the consent of the stockholders, not merely of the management officials. In addition—and this is particularly true

of an investment company—it requires the fullest sort of disclosure both at the time the write-down is made and in subsequent reports, so that the shareholders may correctly appraise the operating history of the company. Such events, however, have been treated quite differently by various companies, with the results I have noted.

I may refer briefly to a case in which a company had for a period of 13 years prepared financial statements, including a profit and loss account and earned surplus account which reflected not only dividends received and expenses paid but also the net profit or loss on its sales of portfolio securities. At the end of the 13-year period there was a very large deficit in the earned surplus account thus computed. It was proposed by the company to reduce the stated value of its stocks and eliminate this deficit and start over on the new basis.

This was not all, however. It was also proposed to create at the start a considerable amount of earned surplus. To do this the company proposed to go back and reanalyze all of its past operations, with the intent of determining the aggregate income from interest and dividends, deducting therefrom the expenses and the dividends it had paid. All losses on securities, instead of being offset, as had previously been the case, against the balance of surplus dividend income, would not be charged retroactively to capital surplus. As a result, the company would have come out with a large balance in earned surplus, by accounting for its operations in a completely different manner than had been followed for some 13 years. Presumably, too, its decisions during that time were based on the results that had been actually recorded in its accounts.

The treatment of dividends paid is of course largely a financial problem, and the accounting represents largely a reflection of what the financial policy with respect to dividends is. However, I might mention one accounting problem of dividends—the method of reflecting stock dividends paid. Even though the New York Stock Exchange has announced certain definite policies, practice varies—since most trusts are not subject to these requirements. In a number of cases, stock dividends may be charged to earned surplus at so small an amount that, although the investor receives a considerable amount of stock as a dividend, earned surplus is not reduced to an appreciable extent. An example of the misleading nature of this practice occurred when a company declared an optional dividend of 30 cents either in cash or, at the option of the shareholder, in stock. Of course, the charge to earned surplus for the cash dividends had to be at 30 cents per share. Dividends declared in stock, although presumably an alternative, were charged to capital surplus at 1 cent a share.

Before leaving the subject of prescription of uniform accounts, I should like to note in passing that section 31 (a), as contrasted with section 31 (d), is applicable not only to registered investment companies, but also to other types of affiliates of registered companies, such as managers, investment advisers, distributors, and principal underwriters. This section, as I read it, gives the Commission authority to require certain information to be kept by these classes of people.

With respect to subsidiaries which are engaged in a related line of business or which are performing management or investment functions for the investment trust, the ability to require particular information to be included in the accounts seems necessary to insure the observance of any classification of accounts established for the investment

trusts themselves. Moreover, in order to insure observance of a number of the provisions in the other sections of the bill, it is, I think, necessary to be sure that the records of affiliated depositors and so on are required to contain the minimum of information necessary for the proper administration of the bill.

One of the principal parts of the reports which section 30 authorizes the Commission to require of investment companies will of course be the financial statements. Financial statements included in such reports are the ultimate goal of the power to prescribe a uniform classification of accounts. A necessary adjunct of the classification sections is, therefore, the control of the presentation of the information required to be kept in the accounts. This is given in general terms by section 30 (a) of the bill. Some may inquire, in view of the examination powers granted by section 31, as to the need of a certification of the statements by independent public accountants. I should like to emphasize here that to my mind certification by independent public accountants would serve a very useful purpose. While perhaps the examination sections would give the Commission the power to make frequent and extensive examinations, I have not conceived of them as examinations of sufficient regularity or indeed of such extensive scope as to supplant the usual annual or quarterly audit by independent accountants. It seems to me that such annual or quarterly audit should contribute to efficient and careful management, insure observance of the classification through review of the accounts and business, and should serve its normal function of deterring defalcations, aberrations, and unintentional errors, as well as to detect them after they have occurred.

Section 30 (c) gives to the Commission the power to prescribe the nature and minimum scope of reports to security holders or classes of security holders. This directly raises the question of the adequacy of reports to stockholders at the present time. I think there is no question that during the past 10 years, through the heightened interest in accounting and finance and particularly through the influence of the Securities Act and the Securities Exchange Act, there has been a marked and continued improvement in the scope and nature of the financial information reported to stockholders. While this improvement is clearly noticeable, there nevertheless remain a great many cases in which the reports do not measure up to what appears to be the average or indeed the prospectus standards of the Securities Act. I have recently, as I think I mentioned, looked over a number of the 1939 annual reports by investment companies. These ranged all the way from a 1- or 2-page leaflet to a 20- or 30-page booklet, naturally dependent to some extent on the size of the company. Looking at them physically, there was a wide variety of methods of presenting the information to shareholders. Also it was by no means possible, from the facts given, to compare the companies directly. There was a tendency, naturally, for companies in the same sphere of influence, either through the same management or the same certifying accountant, to be more or less uniform.

As between unaffiliated companies with different accountants, there were wide differences both in the mechanics and substance of the presentation. In some cases portfolios were given in great detail. In other cases there was merely a summary statement followed by a list of shares held, without an indication of the cost or market value

of any of them. In very few cases was there a statement of both the cost and market. While most reports displayed a statement of net asset values, frequently no mention was made of a class of shares which had a negative asset value by virtue of the preference of prior shares.

The variations in the methods of accounting followed, which I pointed out earlier, were of course reflected in the statements, and may be worth repeating here. To take one item alone—the basis of carrying securities—the following methods were found: Cost; market value as of a specified date with subsequent additions at cost; market; cost or market; whichever is lower; and "cost or less."

While aggregate unrealized depreciation or appreciation was in all cases given, the manner of presenting it varied widely. In some cases it was treated as a collateral notation; in others, as the basis for a separate statement in comparison with realized profit and loss; in others, as a reserve; in others, as an adjustment from surplus. Depending on the method, a company whose securities had depreciated might show a large earned surplus, with only a note as to the depreciation; or it might show a deficit in earned surplus. Similar variations were found in the method of handling realized profits and losses on securities sold. In one case, profits and losses on the sales of securities on hand at a given past date were carried to one surplus account, while all profits and losses on securities acquired subsequent to that date were carried to another surplus account.

In some cases, exception to the methods followed by the company was taken by the accountants in their certificate; but the certifying accountant is not always in a position to force a particular company to utilize any particular set of accounting principles. While he may have strong convictions of what should be done, his alternatives are only to withdraw from the engagement, or, if he feels the variation is not too gross, to qualify his certificate in an appropriate manner. The building up of a professional approval of a group of principles would doubtless have a strong moral effect upon investment trust management, but the mere existence of recognized principles would not necessarily mean that they would be followed by all. Moreover, a feeling of confusion is inescapable, it seems to me, when the company follows one principle in its statements and when the accountants are forced to take exceptions thereto in their certificate. In some cases, the underlying trust indentures themselves prescribe accounting methods completely contrary to recognized practice.

Inasmuch as the most direct method of apprising the stockholders and prospective purchasers of the condition of a company is perhaps its annual or quarterly report, leaving aside for the moment the Securities Act prospectus, I feel that some measure of minimum disclosure as well as frequency of reports ought to be obtained for this type of company. It will be recalled in this connection that reports to shareholders are not directly covered by the Securities and Exchange Acts.

I should like next to mention very briefly one or two accounting problems with respect to dividends. As I pointed out earlier, accounting generally does no more than seek to reflect in the accounts the financial policy as to dividends. However, it must not be forgotten that to a very large extent the dividend policy is based on the results of operations as revealed by the method of accounting used.

Thus, incorrect methods of reflecting, in income or surplus, amounts representing the receipts of stock dividends, rights, profits on sale of securities, and the like, would inflate or depress the income account, and so might affect the dividend policy. Failure to provide for security losses or understatement of them would accountingwise result in earned surplus when actually there was none, and so dividends apparently paid from earned surplus might in fact be out of capital.

Section 19 as to dividends, as I read it, attempts merely to provide the recipient of a dividend with a clear indication of whether the dividend represents income on securities, trading profits which to a great extent may be dependent upon the course of the market in general, or a return of capital. It does not attempt, except by the asset ratio provision, to determine when dividends may or may not be paid. However, thereis a good deal to be said, in view of the extremely liberal corporation laws, in favor of laying down some standards. The difficulty is, of course, in taking into account the differences between types of trusts. For example, ordinary income to a diversified company ought probably to be available for dividends, without regard to security profits or losses. In a trading company, however, it would seem that not only realized profits and losses on securities should be taken into account but also an appropriate provision for unrealized losses.

As between the open-end and closed-end type of companies, there perhaps should be other differences, since the former in effect are engaged in a continual process of paying out appreciation in securities, through their redemption policy. If there have been losses, of course the redemption price also takes these into account. Finally there is a problem, at least with existing companies, of having two or three issues of securities with varying rights and privileges. I do not see how positive dividend requirements can be drafted without taking into account different types of trusts, such as I have mentioned, and the existence of varying classes of securities. Such a dividend provision would, of course, be lengthy. Among other things, the present asset ratio provision would have to be adapted more precisely to the varying classifications, in view of the positive dividend standards. Another possibility would be to lay down a few general principles within which the Commission was to work out detailed rules applying these principles, in collaboration with members of the industry.

Section 32, you will recall, requires that the independent auditors be elected by stockholders rather than be appointed by the persons who are also directly responsible for the transactions which the auditors are reviewing. It seems to me that, under present circumstances, the independent auditor is reviewing the operations of the company, including the activities of the operating management, with the puropse of expressing an opinion on the financial statements to be relied upon by stockholders and prospective stockholders. It is important, since the statements are to be used by this class of people, that his responsibility to them be strengthened as much as is possible. This method of selection, it seems to me, will give the auditor a greater sense of direct responsibility to the stockholders and should confirm him in his role of advocating a full and fair disclosure of the facts, even though those facts may not be as favorable as some would wish. This method of electing auditors is not, of course, a penacea for all of the problems of providing good reports for stockholders. It

does, I think, point in the right direction. It has been widely recommended by various groups. There has been some objection raised to it, on the ground that the stockholders are not in a position to determine what accountants are professionally equipped in experience and manpower to deliver the necessary services. It may be that this could be overcome, quite simply, by requiring that any nomination by the management at the stockholders' meeting be required to be made by a nonmanagement committee of the board of directors, which would also be responsible for the details of the audit engagement, and would be required to receive and consider the report and suggestions of the auditors.

Section 32 (b) attempts to do much the same thing with respect to the principal accounting officer of the company. It requires him to be elected by the stockholders or by the board of directors. The principal advantage in this method of selection is that it establishes a direct source of information to the board of directors, as distinguished from the operating management. This principle has been endorsed, with respect to corporations in general, by the New York Stock Exchange, by the Controllers Institute of America, and by others. In any event, such procedure would, I think, aid in furthering a system of checks and balances, within the management, against abuses of direct mismanagement and minor and major defalcations.

The final section which I wish to comment on briefly is section 32 (c) (1). This section authorizes the Commission to prescribe the minimum scope of, and procedures to be followed in, any audit of a registered investment company. This, I think, is a very delicate question. I have not the least doubt that the prescription of minimum procedures and minimum scope would be useless if the auditors were incompetent or were careless and lacking in alertness and intelligence. In other words, an adequate audit is composed of two essentials: an adequate program and an intelligent execution of it. Moreover, in the great variety of situations which an auditor may be called upon to face, it is utterly impossible to prescribe all of the steps which he he should take under varying circumstances.

It has also been said with a great deal of justice that the mark of a good auditor is the series of supplementary tests which he makes in view of having seen or discovered certain things, rather than his ability to follow a set procedure. To take one example of this, there is the question of checking or physically verifying the existence of the portfolio securities. It would be easy to require, let us say, that securities in all cases should be examined. If, however, a reputable custodian held securities for several trusts, physical verification might be less valuable than a confirmation by the custodian. Unless the securities were physically segregated or identified in some way so that substitution was impossible, the auditor would have little means of knowing, when certain securities were shown him, whether these were the securities of the trust under audit. Presumably he would not be able to audit at one time all of the securities held for several trusts. In cases in which physical confirmation is necessary, a great deal of its value depends upon the safeguards which the auditor is able to set up against substitutions of securities, double counting, and the like. Moreover, much of the value of the audit depends upon the evidence he may accumulate as to whether the securities have at all times been devoted to the uses of the company and have not during the period

been misappropriated for use as private collateral or otherwise. There is the one further danger, of course, that in any prescription of minimum procedures, the result is that a maximum scope will result.

On the other side of the picture, there have been a number of cases, although examples are relatively rare today, in which the auditor's examination of investment trusts has been less in scope, whatever the quality of the examination, than is reasonable and desirable. These cases would, I feel, be avoided by the prescription of minimum rules. Many of the difficult problems of the auditor would be solved by the existence of a uniform classification of accounts, since a great deal of his work lies in the field of expressing his opinion as to the accounting principles involved and in persuading the company as to what are the best principles to be followed. Also, as I have pointed out above, the problem of auditing an investment trust, in comparison to the audit of a commercial or industrial concern, is relatively simple, since the investment company's assets are few in number and have many common characteristics, its liabilities are limited in character, and the general problems of operation are simple.

For these reasons, it seems not at all impossible to prescribe a minimum procedure. This might be done, for example, by prescribing merely that a financial statement would not be accepted as certified unless certain required audit steps had been completed to the satisfaction of the auditor. To avoid giving the impression that what was prescribed constituted a complete audit program, the steps prescribed could be made so obviously a skeleton as to leave to the auditor that field in which his discretion is most important, namely, the selection or even invention of steps to meet special problems which he finds in a particular case. It might be satisfactory merely to have a general rule: For example, that a statement would not be accepted as certified unless the certificate of the auditors affirmatively represented that the audit made was not less in scope in any respect than that advocated by the accounting profession. Perhaps the rule might read that the audit was to be not less in scope than was necessary to present comprehensive and dependable financial statements.

Senator HUGHES. (presiding). The auditors who testified here before the committee seemed to think that they were a profession of high standards and regulations, and so forth, and should not be disturbed at all or regulated in any particular, or any suggestions made as to how they should do their work.

Mr. WERNTZ. Senator, I think they are a profession of high ideals.

Senator HUGHES. Yes.

Mr. WERNTZ. But I think we can assist them in policing their own profession, by securing to them these advances that they agree upon.

Senator TAFT. What is it you want to do about that? I have not looked at that part of the bill.

Mr. WERNTZ. I am not sure that the language in the bill as it is written is the best approach; but I think the Commission should have sufficient powers to insure that the term "certified statement," as filed with it, means certified upon the basis of an examination which auditors in general would believe was sufficient.

Now, Senators, we can tie that either to their own procedures or to certain minimum procedures that the Commission might adopt, after consulting them, or to some abstract standard, such as sufficient to present comprehensive statements.

Senator TAFT. Do you provide for an audit by the Government?

Mr. WERNTZ. We provide for an examination.

Senator TAFT. An examination?

Mr. WERNTZ. But I have not conceived of those as being sufficiently regular or necessarily as extensive as you would need.

Senator TAFT. I do not know; but I have been on a bank board where it almost seemed to me that the private audit was superfluous, with the type of Audit that the Federal Reserve Board today makes of a bank. The money paid for an outside audit seemed almost an unnecessary expenditure.

Of course, directors do want it, because they want to be sure what it says; but the stockholders of a bank rely entirely upon the Government's statement, really, in the end, rather than upon the private audit.

Mr. WERNTZ. Well, under these examination sections, I had not conceived of a regular or surprise basis of examination to that extent, but rather of special performance examinations, in view of violations and things of that sort.

Senator TAFT. I do not see the purpose of regulating private auditors if you are going to audit the thing yourself.

Mr. SCHENKER. May I say something, Senator?

Senator TAFT. Yes.

Mr. SCHENKER. That section with respect to examinations by the S. E. C. is not comparable to examinations by bank examiners. It had its genesis in the suggestion made by Earle Bailie, who is chairman of the board of Tri-Continental, that the most effective thing you can do is to have the power, if you suspect that something is wrong, to send somebody in to take a look at their books.

It does not contemplate regular examinations to see if their books balance, or anything of that sort. This is really a supplementary power to the investigatory powers of the Commission.

Here is what Mr. Bailie said, in his statement which he read at our public examination, and which he sent to his stockholders [reading]:

> It seems to me that both the investing public and the investment company management would benefit from some method of providing assurance to the public and to shareholders that the provisions of any regulation are being adhered to scrupulously and carefully.
>
> As a possible means of providing such assurance, I venture to suggest periodic verification of security holdings and review of transactions by a bureau of examination and audit, to be set up by the Securities and Exchange Commission for that purpose. The function of the bureau would be similar to that of the national bank examiners, in that it would verify security holdings and review the transactions of the investment company at periodic intervals.
>
> Any report of criticism, based on such examination, would be sent to the directors of the company, for their attention and action; and the failure of the directors to take appropriate action within a reasonable time should permit the bureau to put its findings before the shareholders themselves.

I think he goes even closer to a national bank examiner's audit than we envision, Senator.

What we felt was that you just cannot tell, unless you have a chance to go in and take a look at the books, when you think something is wrong, really; and I do not think it is contemplated that we shall have the same type of thing that you have with the national bank examiner, and have a big staff of auditors to go and make an audit of the company.

Isn't that so?

Mr. Werntz. That was my understanding of the difference.

Senator Taft. Offhand it seems to me more important than any of the rest of the bill; I mean that I would rather have that than all the rest of the bill put together—just from what I have heard here. It seems to me more likely to eliminate all these abuses than all the different kinds of regulations you can make.

Mr. Werntz. When coupled with the uniform requirements.

Senator Taft. Of course, you would have to have uniform statements.

Mr. Werntz. That is what I mean.

Mr. Healy. Do you mean the accounting regulation or the power?

Senator Taft. I mean the right to inspect and the more or less periodical examinations and certification of the statement that goes to the public as an official statement guaranteeing that the Government has checked.

Mr. Healy. If that were carried out well and quite extensively, I think it is entirely possible that you might consider at least dispensing with the work of private auditors.

Senator Taft. I did not think so much of dispensing with the work of private auditors, but merely that if you did that, I did not see why you should bother with the private auditors. You can let them do as they please. You have rules that the auditors would have to comply with, and they are going to have to follow the rules that the Government inspectors certify; they cannot make the audit different. They may examine different things; but when they finally come out with their statement, they are bound to follow what the Government prescribes with respect to their statement.

Mr. Healy. They are bound to follow what the Government prescribes in accounting; but if the bill is changed, they will not be bound to follow what the Government prescribes as to auditing; and the bill gives the Commission the power to prescribe the auditing.

Senator Taft. I mean that I did not see what difference it made to the public. If the Government audits, it does not make much difference to the public how complete the private audit is. That is for the directors to determine.

It seems to me they would say, "We do not want a complete private audit; all we want is this thing covered, that that thing involved."

Mr. Werntz. There may be a different type of certification. That is to say, if the auditors have not made the type of examination which the profession itself believes to be the basis for such a certificate, then they may in effect be expressing an opinion without a satisfactory examination; and this provision is for that.

Senator Taft. Do you have the S. E. C. regulating the auditors?

Mr. Werntz. No. We have this provision to the effect that certified statements are required; and then we have a brief rule which says that, in effect, it shall be the same as the industry requires.

Senator Taft. The problem seems to be no different for the investment trusts than for all the other forms of security-holding and investment companies.

Mr. Healy. The problem continually is what is an audit? That is the problem we continually are confronted with, in considering the statements we get. They say it is a balance-sheet audit or a detailed audit. There does not seem to be uniformity of definition.

However, under Mr. Werntz' suggestion—which I may say is acceptable to the Commission—that part of the bill would take some rewriting.

Senator TAFT. What is the section?

Mr. WERNTZ. That is section 32, I think.

Mr. HEALY. We have had so-called audits with certificates, where the auditors did not verify the portfolio.

Mr. WERNTZ. Page 73, line 17.

Senator HUGHES. They checked on the information given them about particular things, but they did not make a complete audit and were not certifying that they had done so?

Mr. WERNTZ. They very rarely make a complete audit.

Senator HUGHES. So, so far as the public was concerned, it was of no value at all.

Mr. HEALY. The question always recurs, "What do you mean when you say, 'I have audited'?"

Senator HUGHES. Yes.

Mr. HEALY. Nobody has ever given a completely satisfactory answer, that I have heard.

Senator HUGHES. While you are looking up that, I do not want to take you away from the subject of the audit, but I should like to say at this time that Senator Wagner has sent over to me correspondence that has passed between the Federal Reserve Board and the Commission, with respect to duplication of Federal supervision. There are letters and answers; and I suggest that they be put in the record for our information.

(The letters referred to are as follows:)

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, April 22, 1940.

HON. ROBERT F. WAGNER,
Chairman, Committee on Banking and Currency,
United States Senate, Washington, D. C.

DEAR SENATOR WAGNER: This refers to your letter of March 15, 1940, requesting a report from the Reserve Board on the bill, S. 3580, relating to the registration and regulation of investment companies.

The Board is advised that the evidence submitted to your committee discloses the desirability of legislation which will provide for adequate regulation of investment companies in the interest of the public and in the interest of investors. It is understood that representatives of the Securities and Exchange Commission and of investment companies are submitting detailed comments to your committee with respect to the various provisions of the bill, and the Board will not undertake to comment on all of these provisions.

The Board has noted that enactment of the bill in its pressent form might result in duplication of Federal supervision of banks and holding companys affiliates of banks. The Board feels that such duplication of supervision should be avoided and to that end representatives of the Board have discussed the matter with representatives of the Securities and Exchange Commission, and the Board and the Securities and Exchange Commission are in agreement that certain amendments should appropriately be made to the bill to avoid such additional duplication of supervision.

These amendments are described in some detail in the attached copies of correspondence between the Board and the Securities and Exchange Commission and are to the following effect:

Amend section 3 (c) of the bill by adding an additional paragraph as follows:

"Any holding company affiliate, as defined in the Banking Act of 1933, which is under the supervision of the Board of Governors of the Federal Reserve System by reason of the fact that such holding company affiliate holds a general voting permit issued to it by such Board prior to January 1, 1940; and any holding company affiliate which is under such supervision by reason of the fact that it holds

a general voting permit thereafter issued to it by the Board of Governors and which is determined by such Board to be primarily engaged, directly or indirectly, in the business of holding the stock of, and managing or controlling, banks, banking associations, savings banks, or trust companies. The Commission shall be given appropriate notice prior to any such determination and shall be entitled to be heard."

Make such amendment as may be necessary to exempt from the "investment adviser" provisions of the bill those holding company affiliates which are exempted from the provisions of the bill relating to investment companies.

Make an appropriate amendment to section 26 (a) of the bill to make it clear for the purposes of such section that at least in the case of any trustee which is a member bank of the Federal Reserve System the statement of the trustee's combined capital and surplus in its most recent published report of condition shall be conclusive.

The Board recommends that such amendments be made to the bill.

Very truly yours,

CHESTER MORRILL, *Secretary.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, April 18, 1940.

Re Investment company bill (S. 3580).

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, D. C.

GENTLEMEN: The Securities and Exchange Commission is prepared to recommend to the subcommittee of the Banking and Currency Committee of the Senate, before which hearings on the above bill are currently being held, that the bill be amended in the following respects:

1. By adding to section 3 (c) an additional paragraph which will exclude from the definition of "investment company" those bank holding-company affiliates which hold general voting permits issued by your board and which are primarily engaged in bank holding-company activities.

The necessity of distinguishing between investment companies on the one hand and those companies which are primarily holding companies on the other is, of course, recognized in the bill. Section 3 (b) of the bill is particularly addressed to this problem, various phases of which are also dealt with in sections 3 (a) (2) and 3 (c) (4). The Commission understands, however, from conversations between members of its staff and members of the staff of your Board, that the exceptions provided in section 3 (b) may not in all cases be adequate to exclude bank holding-company affiliates of the type above referred to. The Commission also recognizes that the determination of borderline cases, which under section 3 (b) (2) of the bill is committed in the first instance to the Commission, can more appropriately be made a function of your Board when the company involved is a bank holding-company affiliate. On the other hand, the Commission feels that in any proceeding of this character before your Board, the Commission should be entitled, if it desires, to appear as a party and present evidence and advance arguments bearing upon the question at issue.

The Commission also deems if of the utmost importance that only those bank holding-company affiliates which are primarily engaged in noninvestment company activities be excluded. In other words, although the letter of section 3 (b) may not be applicable in all of these situations, the Commission feels that the principle of that section should apply. In particular, it is important that the amendment be so drafted that it will not be possible for an investment company to escape the bill by the simple expedient of using a relatively small portion of its assets to acquire control of two or three banks.

2. By making such amendment of paragraph (16) of section 45 (a) as may prove necessary in order to make it clear that the term "investment adviser" does not embrace bank holding-company affiliates of the type above referred to.

3. By amending paragraph (1) of section 26 (a) to make it clear that, at least in the case of any trustee which is a member bank of the Federal Reserve System, the statement of the trustee's combined capital and surplus in its most recent published report of condition shall be conclusive. It is expected that the specific language which will be recommended will closely follow that of paragraph (2) of section 310 (a) of the Trust Indenture Act of 1939.

We should appreciate being advised whether, in principle, the above recommendations meet with your approval. We shall also be glad to consider any precise language to accomplish the above objectives which you may care to suggest.

Very truly yours,

ROBERT E. HEALY, *Commissioner.*

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, April 19, 1940.

Hon. ROBERT E. HEALY,
Commissioner, Securities and Exchange Commission, Washington, D. C.

DEAR MR. HEALY: This refers to your letter of April 18, 1940, advising that, in accordance with conversations between representatives of the Board and members of your staff, the Securities and Exchange Commission is prepared to recommend to the subcommittee of the Banking and Currency Committee of the Senate, before which hearings are being held on the investment-company bill, S. 3580, that the bill be amended in certain respects in order to avoid additional duplication of supervision by Federal agencies of banks and holding-company affiliates of banks.

The Board considers appropriate the suggestion that holding-company affiliates of member banks which obtain and hold voting permits issued by the Reserve Board under the provisions of the Banking Act of 1933 and which are primarily engaged in the business of holding the stock of and managing or controlling banks be exempted from the provisions of the proposed Investment Company Act, since these companies are subject to examination and supervision by the Reserve Board.

As you know, from the information which has been submitted to representatives of your Commission during the conferences which have been held with members of the Board's staff, there are a number of holding-company affiliates of member banks which now hold voting permits issued by the Reserve Board. When it granted these permits, the Board, pursuant to authority given in the statute, in effect determined that such companies were engaged as a business in holding bank stocks and managing and controlling banks. If the Board should be required to make a determination in these cases, it would, on the facts now in its possession, determine that they are primarily engaged in the business of holding bank stocks and managing and controlling banks. Accordingly, the Board feels that it would involve unnecessary consumption of time and expense, both to the Federal Government and the holding-company affiliates, and would not serve any useful purpose, for such a determination to be made in each of these cases. For these reasons, the Board suggests that these holding companies, a list of which has been furnished to your staff, which now hold voting permits and are therefore under supervision and examination by the Board be exempted from the provisions of the proposed investment company act by the terms of the act itself. The Board believes that such an exemption would be in conformity with the suggested principle under which only companies which hold voting permits and are primarily engaged in holding the stock of and managing or controlling banks would be exempted from the provisions of the proposed investment company act. (In addition to the holding-company affiliates to which reference is made above, there are a few banks which control other banks and hold voting permits issued by the Board. However, these are already exempted from the provisions of the bill under exceptions relating to banks.) In order to accomplish the exemption which the Board has in mind, it is suggested that section 3 (c) of the bill S. 3580, be amended by adding an additional paragraph as follows:

"Any holding company affiliate, as defined in the Banking Act of 1933, which is under the supervision of the Board of Governors of the Federal Reserve System by reason of the fact that such holding company affiliate holds a general voting permit issued to it by such Board prior to January 1, 1940; and any holding company affiliate which is under such supervision by reason of the fact that it holds a general voting permit thereafter issued to it by the Board of Governors and which is determined by such Board to be primarily engaged, directly or indirectly, in the business of holding the stock of, and managing or controlling, banks, banking associations, savings banks, or trust companies. The Commission shall be given appropriate notice prior to any such determination and shall be entitled to be heard."

You will observe that under this proposed amendment any holding-company affiliate of a member bank which hereafter desires to obtain a voting permit from the Reserve Board and be exempted from the provisions of the Investment Company Act must, after your Commission has had an opportunity to be heard, be affirmatively determined by the Board to be engaged primarily in the business of holding stock of and managing or controlling banks. It is believed that this procedure would effectively prevent evasion of the Investment Company Act by investment companies which might attempt to evade it by using a relatively small portion of their assets to acquire control of two or three banks.

It is understood from your letter that the Commission will recommend such amendment as may be necessary to exempt from the "investment adviser"

provisions of the bill those holding company affiliates which are exempted from the provisions of the bill relating to investment companies. It is also understood that the Commission will recommend that an appropriate amendment be made to section 26 (a) of the bill to make it clear that at least in the case of any trustee which is a member bank of the Federal Reserve System the statement of the trustee's combined capital and surplus in its most recent published report of condition shall be conclusive.

As representatives of your Commission were advised by members of the Board's staff, the Board has felt for some time that the statutes relating to the supervision of holding company affiliates of member banks should be strengthened. The Board feels that it would be more appropriate to consider these matters in connection with a broad investigation of banking and credit matters such as that which the Banking and Currency Committee of the Senate has been authorized to undertake under the provisions of Senate Resolution 125.

The Board and its staff appreciate the cooperation of the representatives of your Commission in working out this problem.

Very truly yours,

CHESTER MORRILL, *Secretary*

SECURITIES AND EXCHANGE COMMISSION,
WASHINGTON, *April 20, 1940.*

Re Investment Company bill (S. 3580).

Hon. CHESTER MORRILL,
Secretary, Board of Governors of the Federal Reserve System,
Washington, D. C.

DEAR SIR: This will acknowledge receipt of your letter of April 19, 1940, regarding the above bill.

The Commission understands from your letter that, if the Board were now required to determine whether those holding company affiliates referred to therein, which hold general voting permits issued by the Board prior to January 1, 1940, are primarily engaged in the business of holding bank stocks and managing and controlling banks, the Board would make an affirmative determination with respect to each of such holding-company affiliates.

From information which the Board has made available to the Commission, it appears that the bank-holding company affiliates referred to in your letter are the following: BancOhio Corporation; Bank Shares Corporation; Barnett National Securities Corporation; Citizens & Southern Holding Co.; First Bank Stock Corporation; First Security Corporation of Ogden; Florida National Group, Inc.; Marine Bancorporation; Marine Midland Corporation; New Hampshire Bankshares, Inc.; Northwest Bancorporation; Old Colony Trust Associates; Shawmut Association; Transamerica Corporation; Trust Co. of Georgia Association; Trustees, First National Bank, etc.; Union Bond & Mortgage Co.; United States National Corporation; Wisconsin Bankshares Corporation.

In view of certain financial information regarding these companies (which the Board has made available to the Commission in confidence), the Commission, with two possible exceptions hereinafter referred to, readily accepts the Board's conclusion that these holding-company affiliates are primarily engaged in the business of holding bank stocks and managing and controlling banks.

The two possible exceptions to which reference has been made are Transamerica Corporation and Shawmut Association. It is understood that, as of December 31, 1939, the former company had approximately 40 percent of its assets invested in stocks of banks which it controls, and that approximately one-third of its assets consisted of securities of nonbanking subsidiaries, most of which were wholly-owned and operated almost exclusively as adjuncts or virtual departments of controlled banks. Shawmut Association, as of the same date, had approximately one-fourth of its assets invested in stocks of a number of banks; such investment was equal to approximately one-third of its investment in stocks of other corporations; and the total assets of banks controlled by Shawmut Association, consisting substantially of investment securities which are under the control and management of the Association, aggregated several times as much as the amount of its investment in stocks of nonbanking corporations. The Commission recognizes that, despite the fact that a considerable portion of the assets of these two companies is invested in securities other than those of controlled banks, various other factors may properly be considered in determining

whether they are companies primarily engaged in the business of holding bank stocks and managing and controlling banks. In view of the Board's familiarity with the operations of both of these companies, it is felt that it is appropriate for the Commission to accept the Board's judgment in this matter.

Accordingly, the Commission will recommend to the subcommittee of the Banking and Currency Committee of the Senate before which hearings on the above bill are now being held that the bill be amended as suggested in your letter. The proposed wording of the amendment is likewise agreeable to the Commission.

Very truly yours,

ROBERT E. HEALY,
Commissioner.

Mr. SCHENKER. Senator, with respect to that correspondence, this point is involved: There are certain companies which hold stocks of banks. For instance, take one of the Shawmut trusts: It has 20 percent of its assets consisting of majority holdings of a number of banks, and 80 percent of its assets consist of diversified securities. That investment company has qualified for a voting permit as a bank-holding company and, therefore, had to enter into an agreement with the Federal Reserve Board with reference to its supervision of its activities. That is one extreme example.

On the other extreme you have the Transamerica Co., out on the coast, which has a great deal of its assets in banks but which does not own a majority of the outstanding; it owns only 40 percent of the Transamerica Bank. However, it has qualified as a bank-holding company, with a voting permit, with the Federal Reserve Board.

Our purpose by this exchange of letters is to make it clear for the record that these are two situations which exist, that you have the problem, When is it a bank-holding company and when is it an investment company?

We want specifically to call attention to the fact that if bank-holding companies are exempt, that exempts the type of situation such as Transamerica and exempts the Shawmut situations.

With respect to this matter of auditors, Senator, may I say just one word: We have made an analysis of many thousands of auditors' certificates. The fact of the matter is that we took 76 companies and analyzed every certificate that the auditors issued, and we found this—you talk about limited scope of audit: In 50 percent of the cases there was no disclosure as to whether or not the auditor checked the physical custody of the securities—which constitute the only asset the investment trust has.

To indicate what can happen, just consider the C. D. Parker Co. case: The securities were in the custody of the manager and sponsor, C. D. Parker. The auditor testified to the effect that when asking about the custody of the securities, he accepted from the manager the statement that he had the custody of the securities—when as a matter of fact the manager had hypothecated those securities with a bank for a personal loan; and when the company went broke, the investment trust lost its securities.

The purport of that provision, Senator, as I visualize it and as I think the Commission visualizes it, is to set down some minimum requirements regarding what these people should do—to say, "You have got to check the physical custody of the securities," and so forth.

However, the accounting profession, as they appeared here, stated they had no difficulty with any of the other provisions, and they thought that they were analogous to lawyers; and they did not like the idea that anybody was going to tell them how to conduct their business, just as you would be telling a lawyer how to prepare his case.

However, as Judge Healy indicated, we are still talking to them; and I think we can work out that problem.

The thing that persuaded us to put in that provision was the essential fact, "Do you have the physical custody of the securities, which are your only assets, or don't you have it?"

Yet, in 50 percent of the cases, there was no disclosure. I am not saying that in 50 percent of the cases it was not done. In many cases there was the specific statement that he checked with the company or that he got a certificate from the trust company which had custody of the securities; but in 50 percent of the cases there was no specific examination by the auditor.

FURTHER STATEMENT OF ROBERT E. HEALY, MEMBER OF THE BOARD OF COMMISSIONERS, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Healy. I think that I may be under some obligation to say a word on the subject of dividends. As I stated when I first spoke before this committee, I am not in sympathy with the provision on the subject of dividends, that appears in this bill. My brother Commissioners know that, and they have said that it is entirely agreeable to them that I should come here and say what I want to say on that subject. I shall try to be brief about it.

I do not believe, myself, that you can in a statute prescribe a rule on the subject of dividends that will apply to all these various types of trust companies. I think you have got to make differences and distinctions, because there are differences between them. That is one part of my trouble. The next part of my difficulty is that I have a constitutional prejudice, I guess, against the payment of dividends out of capital. We often hear how desirable it is to maintain the record of dividends and how hard it is on the preferred stockholders not to do so; and, of course, I have to agree to all that. Yet, the preferred stockholder has no right to dividends unless they are earned; as a general rule, I think that is the contract: he has a preference on the earnings.

So I have some trouble with all of these situations where the capital contributed by common stockholders or the capital contributed by the preferred stockholders, themselves, is returned to them in the form of dividends.

With 48 States grinding out all the different kinds of laws on the subject of corporations, and with each one trying to outdo the other as to what safeguards can be let down—and it seems to me that is just about the kind of race that we have had, at least in some places—you get some results that are rather startling. I saw a case the other day, that was not an investment trust, where there was a preferred stock which in case of liquidation was to be paid off at $100. It had a $5 dividend rate. Its par value was $1.

We have seen case after case, some of them among investment trusts, where you get this situation: You buy a share of stock—let us

say, common stock—for $30 and under the laws of the State the directors have the right to divide that $30 between the capital stock account and the capital surplus account, just as they please. In many instances the stockholders do not know that; and $25 of your $30 capital contribution may go into a capital surplus account, which of course is a capital account and does not represent earnings; it represents contributed capital. Sometimes it is there available for dividends. I am not sure that it is entirely fair to the common stockholder to use his capital in that manner.

When we turn to the case of the open-end investment trust, it seems to me that every time an open-end trust redeems a share of stock, it is returning to the shareholder his capital contribution at its worth at the time of redemption—either appreciated or depreciated. That immediately raises serious problems as between that common stockholder whose shares are redeemed and the senior security holders, if there are any.

Fortunately, and I think very wisely, a very large percentage of the open-enders have recognized the difficulties and, perhaps, the lack of wisdom of having senior securities in these open-end companies; and the result is that you have less than 6 percent of the open-end industry which have more than one class of stock.

However, when you have, let us say, common stock and debentures or notes, I think a serious question of law arises as to the rights of the debenture holders or creditors, when you turn back to a stockholder his capital contribution. You can hark back to Justice Story's opinion, in 1824, in Wood versus Dummer, when he was in the Supreme Court of Maine. The reasoning of that decision has often been questioned, but very seldom does anyone question that in essence many of these payments are against the rights of the creditors. Likewise, if you have preferred stockholders, very difficult questions arise when you make a capital distribution to common stockholders, and the preferred stockholder still sits there.

Incidentally, since this seems to be a chance to say it, let me state that whatever this committee decides to do with respect to the subject of future senior securities, I beg of you not to permit the open-end trusts to have any more senior securities. It gets them into all kinds of difficulties about accounting. For example, you buy a share in an open-end trust for $30, and a few days later you redeem it for $25, if that is the value, or you redeem it for $35. In one case the trust gives you $5 more than you put in, and in the other case $5 less. I have seen at least three different methods of accounting for that kind of situation, all carried on by different open-enders; and I have to be honest enough to say that I do not know which one is right. I have never talked to anybody who seemed to have a good answer or a good prescription as to how that thing ought to be handled in the accounts.

Senator Taft. The open-end trust really differs from the whole basic idea of corporations, as we have understood in the past.

Mr. Healy. It does; yes, sir.

Senator Taft. Except it is very similar to the building and loan association shares which we have in Ohio, which have the same result; and it really requires almost as completely different kinds of rules for incorporation and for dividends.

Mr. Healy. That is right—and for accounting, I think.

Senator Taft. Yes; and for accounting.

Mr. Healy. That is, I suspect that; I do not know.

Senator Taft. Yes.

Mr. Healy. However, if you have only one class of stock——

Senator Taft (interposing). And the theory that the capital cannot be impaired is washed out completely in that kind of situation.

Mr. Healy. Well, you return capital to the shareholder every time you redeem his share.

If you have only one class of stock, possibly you can get along with that situation without much trouble, if everybody understands it and agrees to it; and possibly the question of dividends does not become so important, because you redeem the share at its market value or its value at the time of redemption, which will reflect market value and any accumulated earnings.

Senator Taft. The only law regarding dividends that would seem to be wise would be that you could not declare dividends except out of earnings, so far as open-end companies are concerned.

Mr. Healy. That might be too strict a rule for open-end companies with only one class of securities.

Senator Taft. Why?

Mr. Healy. I could stand it, but I think the industry might make a good deal of objection to it, on these grounds: that if you have only one class of stock, you are treating everybody more or less alike. If I come in and want to redeem my share, the value at which my share is redeemed will reflect the market value of my share of the portfolio, and it will also reflect any gains or losses that may have taken place.

However, all I can hope to accomplish by what I say is, not to make a good answer, but to demonstrate that the accounting problems and the senior-securities problem and the dividend problem in the open-end trust may be wholly different things from such problems as applied to other types of companies; and these problems may vary even inside open-end companies, when the open-end company has senior securities. If I had my way, I would not permit an open-end company to pay any dividends out of capital while there were senior securities outstanding.

Now may I speak of something else that bothers me, under this dividend provision that is here before us? You have a provision to the effect that if you pay a dividend on a class of securities, you have to maintain a certain asset coverage for the securities above it. I do not remember the figures; but it could work out in this way: Suppose you had a corporation, 60 percent of whose capital was raised by debentures or notes and 40 percent by common stock. You go along for a period of time, and there is absolutely no impairment of the capital. The company accumulates some earnings; but it is not permitted, by these proposed provisions, to pay out those earnings to the common stock, in the form of dividends, although there is no impairment of capital; because before you can pay it out, you have got to increase the asset coverage for the senior securities to a point that is better than the original 60–40.

I am not sure that that is fair to the common-stock holders who went into that situation.

Another point that bothers me in connection with this is the provision for improving or maintaining asset coverage as to senior securities. It does not work in this kind of a situation. Suppose

you have only common stock and preferred stock. You pay a dividend on the preferred stock. There is nothing senior to the preferred stock; therefore there is no asset coverage ratio to maintain.

In that situation there is nothing in this bill that prevents the payment of dividends on the preferred stock out of capital contributed either by the common-stock holder or the preferred-stock holder himself.

Senator TAFT. Are there any provisions in any State law as to any kind of a corporation in which the power to declare dividends is limited on common stock if earned?

Mr. HEALY. Yes, sir.

Senator TAFT. There is some provision that banks have to set aside a certain amount of surplus.

Mr. HEALY. In my native State I think it is the law, unless they have changed it since I left there, that if you pay dividends out of capital; you are subject to fine and imprisonment.

Senator TAFT. I do not mean that.

Mr. HEALY. Oh. I beg your pardon.

Senator TAFT. Is there any provision that limits your right other than by saying that you must have an extra coverage or an extra supply of securities?

Mr. HEALY. I do not remember running across anything of that sort.

Senator TAFT. This strikes me as a novel provision not only for investment trusts but for any kind of a corporation.

Mr. HEALY. We had quite a difference of opinion among the Commissioners, and we discussed this at some length, and I was very much prejudiced against the payment of dividends out of capital.

Senator TAFT. So am I, a hundred percent.

Mr. HEALY. My brother Commissioners thought I was taking too harsh an attitude, and they tried to devise something that would ease off that situation. I am a little fearful that in trying to ease it off they may have made it a little worse. If you asked me to write a provision for all of these corporations, I do not know whether I could do it nor not. It would be a very difficult task. Whether you want to try to put it into this bill, whether you want to handle it as part of the general accounting problem, or whether you want to commit it to the Commission to be carried out in conformity with some definite standard that this committee can write, is a thing that you will have to answer.

Senator TAFT. Mr. Chairman, I will have to leave.

Mr. SCHENKER. On the question of whether there is any analogous situation, the fact of the matter is that every good preferred stock will have a provision that you cannot pay any dividends unless there is a certain——

Senator TAFT (interposing). Why not leave it to them? They have all kinds of fancy provisions. In some they don't and in some they do. I do not think it makes much difference. I cannot see why you cannot leave it to them to decide it. I would not want to express any final opinion about it at this time, because I have not studied it enough.

(Senator Taft withdrew from the hearing room.)

Mr. HEALY. From my discussion I would not want to have it understood that I think the payment of capital gains which have been

reduced by unrealized depreciation is a distribution of capital. It is not necessarily that.

I have one or two other things in my mind that I would like to present. I would like to put in my "two cents' worth" along the same line that Senator Taft spoke; that is, if this Commission is not going to be allowed to have some real power with regard to accounting, it is better to tear the bill up. Accounting is at the heart of the whole thing. I do not think that accounting should be put into a strait jacket and not be allowed to grow and improve and expand or anything of the sort. You can very easily harm the situation by casting accounting standards into too rigid a mold. Improvement comes in this field as time goes on. I think, however, it is necessary to have some real regulation as to accounting. That was Mr. Bailie's recommendation, and I think he was perfectly right about it.

Now I would like, if the committee please, to turn to section 13 for just a moment.

Senator HUGHES. Before you do that, Judge, let me say that I am somewhat concerned about how far the bill should go. If it goes only part of the way and a general impression goes out to the country and to the people who do business with these companies that the Government has control over them and is regulating and safeguarding them, and so forth, it gives a wrong impression.

Mr. HEALY. That is, if you get a half-way bill?

Senator HUGHES. If it is not effective, it is going to be misleading. Probably we had better not do anything at all if we are going to have something that is misleading to the investors.

Mr. HEALY. I think you are right.

Senator HUGHES. I mean, we do not want some half-way measure.

Mr. HEALY. Yes. I think there should be reasonably pervasive regulation.

In discussing section 13 I am not going to try to defend language. I am going to do what I did yesterday—to try to show the committee why the provision was put in, and I shall undertake to prove that it was based, as some of these other provisions were, on some actual experiences that we have had over the last couple of years in administering statutes.

Subsection (b) of section 13 provides that no registered investment company shall change any fundamental investment or management policy unless each such change is authorized by the vote of a majority of its outstanding voting securities.

Then follows the provision that we can designate those things that are fundamental and that we shall give due weight to certain items that are enumerated.

I do not remember, of course, what all the witnesses said about this, but there were some witnesses at least who approved the first sentence of section 13 (b), but thought that the Commission ought not to have the power of defining.

Of course that power of defining that is given there is not, in my opinion, a legislative rule-making power. It is an interpretative power.

I do not intend to battle for it. If the industry and the committee think it ought to go out, it is perfectly all right with me. But let me tell you why it was put in.

A year or so ago there was an amendment made to the Exchange Act of 1934 which made it unlawful to engage in fraudulent and deceitful methods in the distribution of securities; and the Investment Bankers Association—and I can again cite the record on this—appeared before committees of Congress and urged that the power of defining those things should be given to the S. E. C. Their reasoning was this: They said, "If we can get definitions from the S. E. C. and rulings in advance, we know 'where are are at;' otherwise we are going to be subjected to all kinds of suits and trouble."

I thought when I went along with this that I was doing something which would aid the industry and would prevent law suits. Now, let us strike out that second sentence of 13 (b), according to that recommendation, and see what we have got left. We have got a prohibition against fundamental investment and management policy changes. They do not want us to define those things. All right. That means that the courts will define them. It means that every time an investment trust turns around in a way that some bad-tempered security holder does not like, he is going to sue the investment trust.

I think it is far wiser, from their point of view, to give the Commission some power of definition, when you bear in mind that a later provision in this bill states that anybody who relies upon an order or rule of the Commission is protected against liability, even though it be found that the Commission acted erroneously.

If the idea or the purpose is not good and nobody likes it, throw it out. If the idea is a good one and the means of expressing it has been poor, then let us try to rewrite it and make the statement of it as good as the idea itself.

Senator HUGHES. The purpose is the protection of the companies, is it not?

Mr. HEALY. Yes; I suppose the real purpose of that first sentence is so that if the stockholder has gone into the corporation on the basis, say, that it is a conservative company which relies for its income on dividends and interest, but without his knowledge and consent he should find himself suddenly in a corporation that is doing a lot of underwriting and speculating wildly on the New York Stock Exchange, I think that kind of a prohibition is a very necessary thing. But you can, I believe, make the position of the industry easier in the face of that if you can get some kind of power of definition by getting an advance ruling from the Commission. I think the writing of a rule of universal application would be very difficult because so many of these companies will have said different things in selling their securities, and in their charters, and so on. I would not be surprised if every one was almost a law unto itself; but certainly there is some advantage through the administrative process in coming down and finding out, before you do a thing, whether you are going to get into trouble if you do it, and then if you get into trouble you have got protection against suits and injunctions.

I think those are good reasons. The provision is not for my benefit. As far as I am concerned, it can be thrown out if that is what the industry wants.

Now I would like to spend just a few minutes on the subject of the size provision in section 14. So far as I am aware I was not actuated, when I went along with this proposal, by any economic theory based

on the fear of bigness. I notice that Mr. Paul Cabot stopped his trusts when he got to $50,000,000, and I was sorry that there was no opportunity to ask him why he stopped at $50,000,000. The philosophy of it, in general, from my point of view, at least, is that when a man gets to the point where he is managing $150,000,000 worth of investments in volatile common stocks, he has got his hands full and that he cannot do a first-class job for the people for whom he is trustee when he gets above that.

The Commission will find no fault and has no right to find fault if the committee strikes it out. But the Commission wishes to maintain before the committee its position that this would be found to be a wise provision. If the committee thinks otherwise, all right. If you do think so, then perhaps you will substitute a provision for a special report on that subject at some future time. There is nobody in the industry that is within such a short distance of these figures that they are in any trouble from it.

Senator Hughes. I think, Judge, after a large number of witnesses have testified it is pretty difficult to recall just how unanimous the opposition to that provision is among the witnesses who have testified here. Whether they were unanimously opposed to it or whether some were not opposed, we will not know until we have reviewed the testimony.

Mr. Healy. I think that everybody who commented on it spoke against it. There were several who refrained from commenting on it.

Senator Hughes. I thought there were some who did not comment, and I did not know whether they favored it or did not oppose it, or whether the industry as a whole had any unanimous voice on it.

Mr. Healy. I do not know. I must confess that I got the distinct impression that they were against it, but for some reason some of the boys did not say anything about it. I do not know why. Maybe they were against it or maybe they do not care. But the statement has been made here that this is an innovation, that this is one of the most novel things that has ever been proposed in any legislative body, and this fear of size was frowned upon or ridiculed as a sort of senseless phobia.

Now, let us see about that. I would like to submit to this committee that taking off the limitation upon size of corporations is the novel thing. I would like to submit to this committee evidence to show that until comparatively recent times there was hardly a State in the United States that did not limit the size of corporations.

Let me spend just a minute on a little footnote taken from Justice Brandeis' dissenting opinion in *Liggett* v. *Lee* which I think was handed down about 1932. He says [reading]:

> Limitation upon the amount of authorized capital of business corporations was long universal in many States, including the leading ones.

I will skip a good deal of this. [Continuing reading:]

> In some industries the removal of the limitations upon size was more recent.

In the part I skipped he showed how limitations had been removed at earlier periods in some States. Then he goes on, and I will go on with the quotation [reading further]:

> Pennsylvania did not remove the limits until 1905.
>
> Vermont limited the maximum to $1,000,000 until 1911, when no amount over $10,000,000 was authorized if, in the opinion of a judge of the supreme court,

such a capitalization would tend to create a monopoly or result in restraining competition in trade.

New Hampshire did not remove the maximum limit until 1919. It had been $1,000,000 until 1907, when it was increased to $5,000,000.

Michigan did not remove the maximum limit until 1921. The maximum, at first $100,000, had been gradually increased until in 1903 it became $10,000,000 for some corporations, $25,000,000 for others, and in 1917 became $50,000,000.

Indiana did not remove until 1921 the maximum limit of $2,000,000 for petroleum and natural gas corporations.

Missouri did not remove its maximum limit until 1927.

Texas still has such a limit for certain corporations.

So we are not the purveyors of novelty; we are old-fashioned reactionaries. The truth of the matter is since the topic has come up and the ink is flowing in the pen, that about 85 percent of all the things that plague S. E. C. grew out of modern innovations, so-called liberalization of State corporation laws. Under the laws of some States you can pay dividends out of almost anything, including the ashes by the heater in the basement.

There is a phobia in connection with the American worship of size. You get to thinking sometimes that anything that is big must be wonderful. That is not so, in my opinion. Primo Carnera was big but he could not punch his way out of a paper bag. United Founders was big; it was $500,000,000 big, but it was far from wonderful. Even in manufacturing concerns any good economist will tell you that there is a point at which size does not increase efficiency. There is a point where you begin to go down the other side of the bill.

I am not arguing these points with the hope of convincing the committee to leave these limitations in; I am just arguing to show that we are not original in these provisions, that they are not innovations, that they are ideas that found favor with our fathers and grandfathers for a great many years in the United States.

Senator Hughes. Judge, I have a more radical view than that. I think there ought to be a limit to the size of cities, especially when a city gets to a size where so many people have accumulated there that it makes it impossible to police them. I think, if it were possible, it would be a mighty good thing if we could limit the size of cities to, say, 500,000 people.

Mr. Healy. Managing a big city is no more difficult than managing $150,000,000 of common stocks. I think in some of these situations, certainly in the business world, it is not a question how big you are; it is a question of how good you are. If you can keep on being good and doing a good job, then I for one would be willing to have you grow as big as you want to, as long as you keep on doing a good job. My doubt is whether anybody who is not a double or triple Napoleon can run $150,000,000 of common-stock investments and do a good job for the people who have entrusted $150,000,000 to him.

I have a few words that I would like to say, with the committee's approval, with reference to section 33 of this bill. That relates to the matter of the settlement of civil actions. It provides that when there is a representative action brought there shall not be a settlement without an advisory report from the S. E. C. I am stating it crudely, perhaps. I mean, there shall not be a settlement until an advisory report has been filed by the S. E. C. We do not have to approve it or disapprove it, but we do have to write an advisory report and hand it to the court.

That does not apply to the supposititious $50 lawsuit that some witness saw in a bad dream. It applies only to representative actions.

You have heard, and I think it is true, that investment trusts are especially susceptible to suits and strike suits. There is a lot of money there and it is all in a small space and easily handled, and the reputation of the companies is a pretty precious thing; but, after all, the susceptibility of many of these investment trusts to lawsuits is not due to any of those factors at all: it is due to the way some of them have misbehaved—and I want to be careful to exclude the good ones. Of course, these trusts did not send their poorest men down here to testify as witnesses. Mr. Kenyon, and Mr. Groves, and Mr. De Rondes, and Howard Hopson and the rest of those boys did not come down here; there are two or three others that could not come—the warden had the key—but one of the reasons that some of these companies are so susceptible to these actions is that the management has misbehaved. Now, when they get in trouble over it, instead of the fellows that were responsible for the misbehavior settling, the corporation which has already had a slap on one side has to get hit on the other side by defending the suit and buying them out of it.

But here is the peculiar thing about it, as it seems to me. I never heard much about representative actions up in the part of the world that I came from, but I understand the law is that when the defendant settles a representative action with the approval of the court, that settlement is binding on all of the other security holders of the class represented, whether they were parties to the suit, whether they ever heard of it or not, and that it bars an action under certain circumstances, at least, by the corporation.

Now, what happens? A lawyer gets seven or eight clients—they may be a very small fraction of the security holders of the corporation—and he finds that somebody has mistreated the funds of the corporation entrusted to him, and he brings a representative action, and presently there is a settlement. Perhaps there is nobody there except these few people, and very often one of the most interesting or potent elements in the proposed settlement is that the defendants pay the plaintiffs' lawyer's fee which may run from $200,000 to $400,000 or $500,000.

Of course the sight of all that money immediately spurs the plaintiffs' lawyer to reject the settlement. I say that in irony. I think it is only human nature that when a lawyer or anybody else, for that matter, sees $300,000 all in one spot, he gets very much interested in that amount of money. It is a very attractive sight. Whether any of them ever have gotten more interested in the $300,000 or $200,000 fee that their opponent was going to pay them, all of course in the open with the approval of the court, than in the merits of the litigation that they were supposed to be prosecuting, is something that I cannot speculate about.

Having had some slight experience with human nature, and having observed that a great many of those cases are settled when the plaintiff's lawyer's fee is paid by the defendant, it raises a slight presumption in my mind, at least.

The courts have actually had things "put over" on them in those cases. The court is busy. If there were nothing involved except

settling the suit with the plaintiffs actually before the court, we would not be here with this proposal; but when in a representative action the settlement of it binds the corporation so that nobody can sue those defendants again for the same wrongdoing, then I submit it is in the public interest that this Commission be allowed at least to write a report and put it on the desk of the court. That is all we want.

Senator HUGHES. I see no real objection to that, myself, without having considered it carefully. I can see that there may be some of my brothers at the bar who may have objections. I was in contact with one case where the settlement brought a firm of attorneys over $3,000,000; and I suppose they would not look kindly at interference with such a situation.

Mr. HEALY. I should think they would be completely hypnotized if they looked at the money long enough.

May I pass on to one or two other topics? I will not take very long with them. The first is the matter of statistics.

I have discovered that I do not know anything about statistics. I have made the discovery that a great many other people have made, people who thought they knew something about accounting or arithmetic, or even lower mathematics, that that does not necessarily mean that you know anything about statistics. We had a statistical job to do, and one of the things that we wanted to find out was whether the expert managers—these people who were asking other people to give them their money to manage because they were so good at it—really had performed very well. It was a difficult thing to do. I confess I did not know how it should be done. I felt that there ought to be some way of measuring it. It is difficult to appraise the performance. You had to establish a standard; you had to have something to compare it with, and it was difficult. The Commission turned it over to two men that we regarded as competent statisticians. I still think they are competent statisticians. One of them was Dr. Raymond Goldsmith. I would like just briefly to give you his background and training.

He is a graduate of the University of Berlin. He had a research fellowship at the Brookings Institute. He did graduate work at the London School of Economics, London, England. He taught Economics at Carlton College in Northfield, Minn. He has been with the Commission since September of 1934. He is the author of a book, "The Changing Structure of American Banking," and has written various studies that have been printed by the Government.

The other statistician whom I mentioned is Mr. Vass. He is a graduate of Rutgers, where he got his B. A. in 1931 and his M. A. in 1933. He completed his requirements for his Ph. D. at Columbia in 1935. He taught economics and statistics at Rutgers in 1932 to 1935, and he came with us in 1935.

I have no doubt that the industry has on its various staffs men just as competent as those two men. Who is right and who is wrong in this dispute about statistics that developed here before this committee I confess I do not know. I cannot follow them into some of these higher altitudes. I do think that whomever the statistician represented, he did what he believed to be an honest and sincere job. And this is not the first time that differences of opinion have developed pretty sharply between statisticians. In fact, I should be very much

interested if anybody could produce a case for me where two groups of well-trained statisticians had agreed.

When we were preparing report there were some differences inside the staff as to the correct approach. It was discussed and talked back and forth, and finally I said, "I would like to learn the name of the toughest and hardest critic of statistical method in the United States;" and I was given the name of Dr. Wilson of the Harvard Business School. I sent the whole thing to him, and he came back with some recommendations, and he seemed to think it was all right, so we went along with it. So much for that.

As a layman and inexpert in the matter of statistics, here is where I come out. I do not ask anybody to accept this conclusion, but after reading the statistical reports and the reports of the S. E. C. filed with Congress, the impression left on my mind, not scientifically expressed, is just this, that these men who traded in securities in and out of the stock exchange are just about as smart in handling those matters as most of the rest of us, and no more so; and I think that is about what the statistical study proves.

I would like to talk for a couple of minutes now about the matter of dilution. There, again, we get off into mathematics and disputes that I confess I have a great deal of difficulty in following. But there are certain things that do emerge from all that dispute pretty definitely, and I do not think the industry disagrees very much with this, that this problem of dilution, this problem of pricing these redeemable securities, is difficult. It is important to those who buy; it is important to the old security holders of the corporation who are left still remaining in the corporation, and it is very important to the future reputation of this industry. They all recognize it, it seems to me.

Mr. Traylor says there is disagreement in the industry as to how to handle it. I am not surprised at that. It is a very difficult matter. And Mr. Traylor said that he came down here with the idea in his mind that the subject of pricing ought to be left to the S. E. C. under this statute. Well, so did I. I had the same idea. But he says that he changed his mind because of some things that Mr. Schenker and Mr. Bane said in their testimony.

I may have missed something that Mr. Schenker and Mr. Bane said about dilution. I do not recall hearing them say very much about the correct method of pricing, although they did say a great deal about dilution. I can very solemnly say to this committee and to the industry that I don't know what the correct pricing method ought to be. I can say to them that if that matter is left to the Commission they will be given a fair hearing on it, and an effort will be made to find a correct pricing system. And that is precisely what the vice president of Massachusetts Distributors, which is Mr. Traylor's company, recommended to the Securities and Exchange Commission in the letter which Mr. Bane read to this committee yesterday morning.

Now, was there a sufficient basis for Mr. Traylor to change his first opinion because of some criticism that came from Schenker and Bane which he found it a little difficult to take? I submit there was not. I submit that the Commission, as distinguished from its employees, and even the employees themselves, has expressed no opinion on the proper pricing method. It is a difficult problem and a vital one, and nobody is in position right now to solve it by a rigid provision written into the statute.

I do not think it is appropriate to leave as important a matter as that to the Maloney Act association, much as I admire it. They do not cover the whole industry, and it is such an important matter and susceptible to such abuses that it should be a matter of law, and not a matter of mere code practice which people can voluntarily adopt or discard as they please.

There has been some controversy that developed here on the subject of what opportunities the industry had to discuss with or deal with the S. E. C. In my opening I did not think I was criticizing them when I said I regretted that they had not done it. They acted wholly within their rights. I do not care to pursue it any further than just to say this. I have had a typewritten compilation made showing about the following: First, approximately the number of pages of our record devoted to discussions by members of the industry as to what the legislation ought to be; second, a compilation of all memorandums filed with the Commission by various members of the industry on what our recommendations ought to be, and, third, a compilation of the time devoted to conferences with the industry by the Commission and the members of the staff. It is necessarily incomplete, because we did not keep books on it. There is a great deal more than appears in this statement. I will offer it for the record now.

Senator Hughes (presiding). Let it go into the record.

(The document referred to and submitted by Mr. Healy is as follows:)

Conferences With Representatives of Industry

Throughout the period of the public examinations beginning July 1936 and later while the various drafts were in preparation, members of industry consulted with members of the staff of the Study in numerous conferences about the points to be considered in legislation. For example, the following letter from Mr. Earle Bailie, chairman of the board of directors of Tri-Continental Corporation dated January 21, 1937, shows the scope of such conferences and the detail in which the various problems of regulation were considered.

Tri-Continental Corporation,
New York, January 21, 1937.

Dr. Raymond W. Goldschmidt,
Securities and Exchange Commission,
Washington, D. C.

Dear Dr. Goldschmidt: Following your suggestion the other day, I enclose herewith a list of the points that we have been thinking about in connection with investment company operation and practice. I understand that after you and your associates have had an opportunity to go over this list you will send me a note regarding any additional points that I may not have covered. As soon as we receive this additional list and have had an opportunity to find out how much additional work it involves, Paul Bartholet will telephone you and arrange with you for a convenient date when we can get together and discuss the subject.

Faithfully yours,

Earle Bailie.

Points to Be Considered in Connection With Investment Company Operation and Practice

I. Management

1. Management and investment service contracts: should they be prohibited; if not—

(*a*) What should be length of term.

(*b*) Should there be approval by stockholders in all instances.

(*c*) Should basis of compensation be market value of assets, income, realized profits, or a combination of these.

2. Directors:

(*a*) Should any restrictions be imposed on persons eligible to serve on investment company boards.

(*b*) Are directors independent of management desirable.

3. General:

(*a*) Should loans to officers, directors, or firms of which officers or directors are members, be prohibited.

(*b*) Should direct dealings between investment companies and their officers, directors, affiliated companies and 10 percent stockholders be prohibited, or is publicity with respect to such transactions adequate.

(*c*) Is substantial stock ownership by management desirable.

II. CAPITAL STRUCTURE

(*a*) Multiple security company versus common stock structure.

(*b*) What is "ideal" division between senior capital and junior capital.

(*c*) Should issuance of stock purchase warrants and options be restricted.

(*d*) Should any restrictions be imposed upon size of bank borrowings.

(*e*) Should restrictions be imposed upon repurchases of own securities.

(*f*) Open-end versus closed companies.

III. INDENTURE AND CAPITAL STOCK PROVISIONS

(*a*) Advantages and disadvantages of "touch-off" clauses in debentures.

(*b*) Pre-emptive rights; advantages and disadvantages.

(*c*) What is proper distribution of voting power?

IV. DIVIDEND POLICY

(*a*) Are restrictions desirable with respect to dividend payments (e. g., prohibition of dividend payments out of capital surplus, etc.), or is full publicity as to the source of dividends sufficient?

V. PORTFOLIO POLICY AND OTHER ACTIVITIES

(*a*) Should limitations be imposed upon the percentage of an investment company's assets which may be invested in the securities of any other company?

(*b*) Should restrictions be imposed regarding maximum percentage of voting securities of other companies which may be held by an investment company?

(*c*) Should any distinction be made between specialized companies and companies with a diversified portfolio (for instance, a company specializing in tobacco stocks versus a company with a portfolio such as General American's)?

(*d*) Should short term trading be restricted?

(*e*) Underwritings and syndicates; should restrictions be imposed?

(*f*) Trading accounts, puts and calls, commodities, "short" sales: Should such activities be restricted?

(*g*) Should any restrictions be imposed upon directors, officers, and employees with respect to purchasing, holding, and selling securities which are held, being purchased, or sold by their investment company?

(*h*) Problem of interchange of services and information between investment companies and sponsors, affiliated companies, brokers, and nonaffiliated persons.

(*i*) Advantages of broad versus narrow charter powers.

(*j*) Problem of notifying stockholders with respect to changes in investment policy.

(*k*) Portfolio turn-over: Is any restriction desirable?

VI. LISTING OF INVESTMENT COMPANY SECURITIES ON EXCHANGES AND/OR REGISTRATION THEREOF WITH SECURITIES AND EXCHANGE COMMISSION

(*a*) Should listing or registration be made compulsory?

(*b*) Problem of preventing "selling down the river."

VII. REPORTS TO STOCKHOLDERS

(*a*) Material to be covered.

(*b*) Frequency.

VIII. FINANCIAL STATEMENTS AND ACCOUNTING METHODS

(*a*) To what extent is standardization of basic accounting principles feasible or desirable (for instance: Method of determining security profits, valuation of portfolio, provisions for tax accruals, determination of true income, etc.)?

(*b*) To what extent is standardization of method of presentation of accounts feasible or desirable?

(*c*) Should regulations to be promulgated call for details in financial statements such as detailed analysis of expenses; amount, basis of determination, and recipient of management or service fee; special compensation to officers and others in the form of stock, options, etc.; supplementary statements such as a summary of a company's assets at market value, comparative asset values, classification of portfolios by groups, etc.?

(*d*) Should independent auditor's certificate be insisted upon for interim as well as annual reports?

(*e*) How should auditors be chosen?

IX. TAXATION

(*a*) Undistributed profits tax.

(*b*) Capital gains tax.

(*c*) Analysis of mutual investment company provisions in Revenue Act of 1936.

(*d*) Effect of present Federal and State taxes on investment policy and operating performance of investment companies.

Prepared Statements from Representatives of the Industry

While the various public examinations of investment companies were being held, members of the industry also prepared and submitted their own recommendations for legislation. Mr. Floyd B. Odlum, president of Atlas Corporation, presented to the Securities and Exchange Commission on July 2, 1937, a "General Statement and Recommendations on Investment Trust Legislation" (15 printed pages). Mr. Earle Bailie, chairman of the board of directors of Tri-Continental Corporation, Selected Industries, Inc., the Broad Street Investing Co., Inc., and Capital Administration Co., Ltd., all investment companies, and a partner of J. & W. Seligman & Co., presented on July 16, 1937, a statement entitled "Investment Company Regulation" (21 printed pages). Lehman Bros. also issued a statement of recommendations on November 9, 1936, which it later sent to stockholders of Lehman Corporation as "Message to Stockholders of the Lehman Corporation, Recommendations for Regulation of Investment Trusts, filed with the Securities and Exchange Commission, November 9th and 10th, 1936."

All these statements were before the investment trust study of the Commission and were carefully considered before the first draft of October 1937.

On June 30, 1938, Dr. Leland Rex Robinson, connected with the Founders Group, submitted a statement entitled "Statement on Regulation of Investment Companies" (12 typewritten pages, legal size, and exhibits). This and other statements of representatives of the industry were considered by the investment trust study in the preparation of later drafts.

Consultation With Industry on Terms of the Bill

Mr. Arthur H. Bunker, of Lehman Corporation, in his testimony on April 15, 1940 (p. 324) indicated that the industry did not have sufficient time to consider actual provisions of the bill after it was prepared and prior to its introduction in the Senate by Senator Wagner, and House of Representatives by Representative Lea, on March 14, 1940. Mr. Cyril J. C. Quinn, of Tri-Continental Corporation, in his testimony on April 16, 1940 (p. 374), indicated that the Securities and Exchange Commission had not considered the wording of the bill with the industry prior to its introduction in Congress. Mr. Paul Cabot of State Street Investment Corporation, in his testimony of April 15, 1940 (p. 374), made the same charge.

The fact of the matter is that after a more or less final draft of the bill had been completed, but before its introduction in the Senate and House of Representatives, approximately 21 conferences were held with representatives of investment counselors and of various types of companies. These conferences, the first of which was held on May 15, 1939, were actively held from January 23, 1940 until the end of February. A list of these conferences with the representatives of industry who attended is as follows:

LIST OF CONFERENCES HELD WITH MEMBERS OF THE INDUSTRY PRIOR TO THE HEARINGS

May 15, 1939:
- J. L. Thomas of F. I. F. Plan Corporation.
- A. J. Wilkins of Wellington Foundation.
- H. J. Simonson, Jr., of Independence Fund of North America, Inc.

A. G. Geary of Independence Fund Corporation.
Sidney A. Anderson of Independence Fund Corporation.
W. H. Ward of Foundation Plan, Inc.
R. B. Dean of Foundation Plan, Inc.
D. W. Barton of Income Foundation (Baltimore).

June 1939:
Paul Cabot of State Street Investment Corporation.
Hugh Bullock of Calvin Bullock.
Merrill Griswold of Massachusetts Investors Trust.
O. Kelly Anderson of Consolidated Investment Trust.
Robert Adler of Selected American Shares.
Mahlon C. Traylor of Massachusetts Investors Trust.

January 23, 1940:
Paul Bartholet of Tri-Continental Corporation.
F. Wilder Bellamy of National Bond and Share Corporation.
Hugh Bullock of Calvin Bullock.
Raymond D. McGrath of General American Investors, Inc.
Ronald H. McDonald of National Bond & Share Corporation.
Alfred Jaretzki, Jr. of Sullivan & Cromwell.
Cyril J. C. Quinn of Tri-Continental Corporation.
Arthur H. Bunker of Lehman Corporation.

January 28, 1940: Dudley Swim of National Investors Corporation.

January 29, 1940:
Investment brokers who are investment counselors: Messrs. Davis, George, Lago, Dunn, Woerkelar, Fulton, Henson, Glazier, Shields, Woods.

January 30, 1940:
Alfred Jaretzki, Jr. of Sullivan & Cromwell.
Raymond D. McGrath of General American Investors, Inc.
F. Wilder Bellamy of National Bond and Share Corporation.
Arthur H. Bunker of Lehman Corporation.
Cyril J. C. Quinn of Tri-Continental Corporation.
Ronald H. McDonald of National Bond & Share Corporation.
Hugh Bullock of Calvin Bullock.
Paul Bartholet of Tri-Continental Corporation.

February 1, 1940:
Paul Cabot of State Street Investment Corporation.
Merrill C. Griswold of Massachusetts Investors Trust.
Hugh Bullock of Calvin Bullock.
Ferdinand Eberstadt of Chemical Fund, Inc.
W. T. Gardiner of Incorporated Investors.
John S. Myers of Affiliated Fund, Inc.
Mahlon E. Traylor of Massachusetts Distributors, Inc.

February 3, 1940:
A. J. Wilkins of Wellington Foundation, Inc.
Allen N. Young of Income Estates of America.
J. L. Thomas of F. I. F. Plan Corporation.
J. H. Meyers of American Participations, Inc.
Arnold Huber of Hamilton Depositors Corporation.
A. H. Geary of Independence Shares Corporation.
Sidney A. Anderson of Independence Shares Corporation.

February 6, 1940:
Alfred Jaretzki, Jr. of Sullivan & Cromwell.
Paul Bartholet of Tri-Continental Corporation.
Raymond D. McGrath of General American Investors.
Arthur H. Bunker of Lehman Corporation.
Cyril J. C. Quinn of Tri-Continental Corporation.
Ronald H. McDonald of National Bond & Share Corporation.
Leon Cole of Atlas Corporation.

February 8, 1940:
Merrill Griswold of Massachusetts Investors Trust.
Ferdinand Eberstadt of Chemical Fund, Inc.
Edward Conway of Chemical Fund, Inc.
Robert Adler of Selected American Shares.
William T. Gardiner of Incorporated Investors.
Steven Hurd of State Street Investment Corporation.
Henry Vance of Massachusetts Distributors.
John S. Myers of Affiliated Fund, Inc.
Mr. Nyle of Mutual Investment Fund.
Hugh Bullock of Calvin Bullock.

February 8, 1940:
- W. R. Bull of Republic Investors and Sovereign Investors.
- Donald Wheaton of Republic Investors and Sovereign Investors.
- Hartwell H. Bellows of Spencer Trask Fund.
- Walter L. Morgan of Wellington Fund, Inc.
- D. M. Barringer, Jr., of Delaware Fund, Inc.
- Thomas W. Ruth of United Securities Company of Missouri.
- H. C. Shallcross of Fiscal Fund, Inc.
- Alfred H. Geary of Independence Shares Corporation.
- Sidney Anderson of Independence Shares Corporation.

February 8, 1940: Walter S. Mack, Jr., of Phoenix Securities Corporation.

February 9, 1940:
- Robert Adler of Selected American Shares.
- Steven Hurd of State Street Investment Corporation.
- Harris Berlack of New York Stocks, Inc.
- Ferdinand Eberstadt of Chemical Fund, Inc.
- Edward B. Conway of Chemical Fund, Inc.
- William T. Gardiner of Incorporated Investors.
- Hugh Bullock of Calvin Bullock.
- Henry T. Vance of Massachusetts Distributors, Inc.
- Merrill C. Griswold of Massachusetts Investors Trust.
- Mahlon E. Traylor of Massachusetts Distributors, Inc.
- John S. Myers of Affiliated Fund, Inc.

February 9, 1940:
- Ferdinand Eberstadt of Chemical Fund, Inc.
- J. Langdon Sullivan of Commodity Corporation.

February 9, 1940:
- C. A. Johnson of Central States Electric Corporation.
- Oswald L. Johnston of Atlas Corporation.
- Floyd C. Odlum of Atlas Corporation.
- Leon Cole of Atlas Corporation.
- Richard Wagner of Chicago Corporation.

February 10, 1940:
- James N. White of Scudder, Stevens & Clark.
- Dwight C. Rose of Brundage, Story & Rose.
- Mr. Van Cleef of Van Cleef & Hageman.
- Mr. Wood of Van Cleef & Hageman.
- Mr. Standish of Standish, Racey & McKay.
- Mr. Sedgwick of Loomis, Sayles & Co.

February 13, 1940: Charles F. Eaton, Jr., of Eaton & Howard.

February 14, 1940:
- Charles Francis Adams of Massachusetts Investors Trust.
- Mr. Hay of General Electric Co.
- Mr. McEvoy of General Electric Co.

February 15, 1940: Mahlon E. Traylor of Massachusetts Distributors, Inc.

February 19, 1940: Dudley Swim of National Investors Corporation.

February 21, 1940:
- Harris Berlack of New York Stocks, Inc.
- Hugh Long of New York Stocks, Inc.
- John S. Myers of Affiliated Fund, Inc.
- Hugh Bullock of Calvin Bullock.

At these meetings, the substance of the various provisions of the bill were discussed fully with members of the industry. The minutes of one meeting that of January 23, 1940, were reprinted by Lehman Corporation and circulated by this company to all members of the industry. A copy of this pamphlet was introduced in the record.

After these various conferences between members of the industry, members of the Commission and the staff of the Investment Trust Study, the staff of the study and the members of the commission held numerous lengthy conferences to reexamine in detail all suggestions and criticisms made at the previous meetings with members of the industry in order that no phase of any question should escape full consideration.

A comparison of some of the provisions for regulation of investment companies set forth in the memorandum of January 23, 1940, circulated by Lehman Corporation, and the provisions covering the same matters in the bill will show how various changes were made in the draft of the bill to take care of objections of the industry raised during the conferences.

Various companies and their representatives also submitted memoranda, about 40 in number, covering several hundred typewritten pages on particular

points. The scope of these memoranda and the topics discussed are indicated in the list attached hereto.

Memoranda Submitted by Members of Industry

MANAGEMENT INVESTMENT COMPANIES

Affiliated Fund, Inc. (John Sherman Myers), February 1, 1940:
On behalf of open-end companies relative to senior securities.
Affiliated Fund, Inc. (John Sherman Myers), February 7, 1940:
Various points in part 3, chapter V, in relation to open-end companies having senior securities with particular emphasis on touch-off clause.
Affiliated Fund, Inc., February 2, 1940:
Unamortized discount of debentures and payment of dividends out of paid-in surplus plus annual reports and dividend notices.
Atlas Corporation, February 15, 1940:
Investment company to designate its type on registration and not to change except with consent of the Commission.
Nine months delay before act becomes effective.
No restriction of dividends out of earned surplus.
Once preferred securities, same tax rights to apply to all.
Should not force underwriting to be done through a subsidiary.
Objects to cross-holding provision, the management contracts being cancelable with 60 days' notice, not being able to sell stock at less than asset value.
Boston Fund, January 30, 1940:
For administration of two or more funds.
Boston Metal Investors, Incorporated, February 3, 1940:
Memorandum Re proposal that after 1 year there shall be no interlocking officers and directors between different investment company systems.
Century Shares, February 5, 1940.
Compensation of management on basis of percentage of assets on a specified date.
Custodianships.
Brokerage affiliations.
Voting privileges in Massachusetts Trust.
Chemical Fund, Inc., February 3, 1940.
Memorandum Re the segregation of management and distribution of open-end mutual investment trusts.
Re proposed restrictions on the formation of sponsors of an existing trust of new trusts, including trusts for underwriting, speculative, or other purposes.
The Chicago Corporation, February 8, 1940.
Intermediate financing generally by investment companies.
Delaware Fund, Inc., February 2, 1940.
Directors interlocking with other investment companies, banks and insurance companies and portfolio companies.
Segregation of management and distribution.
Common administration of more than one trust.
Suggested antiswitching law between funds under common management.
Interlocking directorships in investment companies.
Annual renewability of management contracts and of distribution contracts.
Letter of February 8, 1940, re limitation of switching between commonly managed trusts and limitation of size.
Separation of management and distribution.
Renewal of management contract.
Importance of legislation that shares be sold between 10 and 3 p. m. at a price to be fixed at the close of the market.
Borrowing.
Reasonable limitation of load.
Eaton & Howard Management Funds, January 31, 1940.
Memorandum for the management of more than one fund by one organization.
Common management and distribution.
Regarding regular voting by beneficiaries or shareholders of investment trusts or investment companies.
Dividend restriction.

Eaton & Howard Funds—Continued
Common control of management and selling.
Fidelity Fund, January 31, 1940.
Duration of contract between investment company and underwriter.
Separation of management company and underwriter.
Directors of banks and insurance companies as investment company directors.
Rapidity with which new trust can be organized by any one organization.
Pricing policy.
Load.
Letter of January 30, 1940, to Griswold against underwriting contract being limited to 1 year.
General Capital Corporation, February 7, 1940.
Re having only minority on board.
Groups Securities, Inc., memorandum to Mr. E. B. Twombly from Herbert R. Anderson, February 9, 1940.
Re limiting short-term profits to 30 percent of total income.
Re one investment company buying another.
Re cross-ownership.
Re interlocking investment company officers and managers.
Re underwriter being an officer where he is not the manager.
Re formation of new trust by same sponsor.
Re registration of independent directors.
Re annual renewal of management contract.
Re "arm's length" dealing.
Re restriction on change of directors.
Re restriction on payment of dividends.
Re reasonableness of load and limited transferability of shares.
Hamilton Depositors Corporation, March 9, 1940.
Objection to 50 percent limitation on load in first year—restriction as to size of down payment.
Independence Fund of North America, Inc. February 5, 1940.
Advantage of trust form against majority vote in corporation.
Keystone Custodian Funds, Inc., March 9, 1940.
Schedule of eliminations and substitutions during 1939 on various funds.
Lehman Corporation, March 7, 1940.
Study re trading and portfolio securities where Lehman Corporation had directors.
Study re relative percentages of outstanding capital owned by Lehman Corporation in portfolio companies.
Massachusetts Distributors, Inc., February 26, 1940.
General advantages of open-end companies.
Possibility of limiting the expenses to 1 percent exclusive of taxes, brokerage and interest.
Dividend policy except for tax reasons.
Capital gains should not be paid.
Re limitation on size.
Massachusetts Investors Trust, January 31, 1940.
Re limitation of size of investment trusts.
Massachusetts Investors Trust, January 31, 1940.
Re possible prohibition of trust "systems."
Massachusetts Investors Trust, January 31, 1940.
Payment of dividends and reinvestment of capital.
Massachusetts Investors Trust, January 31, 1940.
Voting rights in open-end trust and removal of trustees.
Massachusetts Investors Trust, February 6, 1940.
Re interlocking directorships.
Massachusetts Investors Trust, February 3, 1940. (two letters).
Management running more than one trust and segregation compelling disposal of Supervised Shares.
Underwriting.
Money for new or small companies raised from capital contributed by investment trusts.
Massachusetts Investors Trust, February 3, 1940.
Re limitation on size.
Massachusetts Investors Trust, March 5, 1940.
Open-end companies not dangerous from point of view of size.

National Investors Corporation, February 6, 1940.
Increasing portfolio diversification requirements to 7½ percent.
Exemption from all excess profit taxes.
Necessity of distributing capital profits in cash to qualify for tax exemption.
"Aging" as a restriction on trading.
Tax law difficulty today requiring distribution.
Recognition of distribution paid out in redemptions.
Special Stock Exchange arrangements for investment trusts.
New York Stocks, Inc., February 3, 1940.
Re senior securities in open-end companies.
Re common management of two or more investment companies.
New York Stocks, Inc., February 6, 1940.
Memorandum against segregation of distribution and management.
Selected American Shares, Inc., February 8, 1940.
Re segregation of management and distribution in open-end companies.
State Street Investment Corporation, February 2, 1940.
Re administration of one or more funds.

INVESTMENT COUNSEL

Berle & Berle, January 29, 1940.
Re investment advisers legislation, supplemented by another letter on February 2, 1940.
Estabrook & Co., Boston, February 2, 1940.
Special Committee of the National Association of Securities Dealers in regard to the proposed sections covering investment counsel in the proposed law regulating investment trusts.
Scudder, Stevens & Clark, February 9, 1940.
Re proposed regulation of investment counsel funds.
Re administration of more than one fund.
Re independent majority of board.
Re restrictions on dividend.
Standish, Racey & McKay, Inc.
Re proposed regulation of investment counsel.

Mr. HEALY. We also have a compilation of the various recommendations made by representatives of the industry. We offered this once in our opening and then withdrew it. I do not know whether it is wise to encumber the record with so much printing or not. If it is filed as an exhibit it would not have to be printed.

Senator HUGHES (presiding). It may be filed as an exhibit.

(The compilation of various recommendations made by representatives of the investment industry was filed with the committee.)

Mr. HEALY. That includes the whole text of the exhibit supplied by Tri-Continental.

Mr. SCHENKER. Senators, in section 10 there is a provision which relates to the interlocking of the distribution and management of open-end companies. The majority of the people, as I recall, who came here to testify with respect to that problem are the managers of the investment trusts and also have the distribution contracts, so that they are substantially the same people. In some instances they are not the same people. In Mr. Griswold's case—the Massachusetts Investors Trust—the management is vested in Mr. Griswold and his four trustees and the advisory board. They are separate and distinct and wholly independent of Mr. Traylor's organization, Massachusetts Distributors.

This bill provides, in substance, that the board of directors of an investment trust, that is, a majority of them, have to be independent of the distributors, and that the principal executive officer has to be independent of the distributors. The bill however permits the distributors to act in an investment advisory capacity to the investment

trust. The ultimate decision as to taking or leaving that advice must be with the independent board of directors.

You might ask what prompted us to put in that provision. I will take just a few minutes to see if I cannot indicate the problem and what we intended to do.

In the first place, take this dilution problem. Mr. Bane indicated that a substantial portion of the securities of open-end companies was sold in the high points of the market. The management is interested in the selling of securities, because these sales increase the size of the fund and therefore increases the management fees. If the manager is the same individual as the distributor he is also interested in the distribution load.

In that situation you have no independent check by any independent people to see whether it is to the interest of the shareholders that the shares be sold at that time and have this dilution take place.

Where you do not have a segregation between the distributor and the manager there are two motivations for increased sales. He not only gets the management fees, but also the distribution load. We say that in those circumstances there ought to be an independent board of directors to look after the shareholders, because the management and the distributor can look after themselves.

That is No. 1. Even more fundamental than that is this problem. These open-end companies sell their securities continuously. They do it for two reasons. One is to increase the size of the fund, and the other, of course, to overcome the redemptions by some shareholders. If they did not sell continuously and they had a lot of redemptions, the size of the fund would shrink and maybe ultimately disappear. So, to counteract those redemptions, they sell their securities continuously.

Then what happens? I do not think anybody will effectively deny this. When the salesman goes out and sells these investment trust securities, an investor may ask, "What securities have you in your portfolio?" and the salesman will show the prospect the portfolio. What is the consequence of that disclosure? The result is that in our opinion—and it really is not denied—there is a pressure on management to invest in certain types of securities, not because they think these securities are the best investment in the world to make at that time, but because that type of security is popular among the people at that time. If an open-end company is selling its securities at a time when war babies are popular, if the company does not have war babies in its portfolio it will not be able to sell the investment-trust securities even though the management feels that war babies are the worst investment in the world to make at this time. If alcohol stocks, as they were in 1933, are popular, unless the investment company had alcohol stocks in its portfolio it might not be able to sell its investment trust shares.

As a result we feel, and it is not really denied, that there is a pressure on managements to make certain investments, not because they think they are good investments, but because it will help their sales campaign. We say that under those circumstances we feel that there cannot be a complete unity between management and distributors and that there ought to be an independent insulation to protect the investor against that type of activity.

Mr. Eberstadt went even further and said that he felt that the board of directors should not only be independent from management but the directors should be independent of each other.

It is to meet that situation that we say there should be an independent board of directors and an independent principal executive officer. We say that if you want to act as investment adviser you can act as investment adviser and get a fee for this advice, but the ultimate decision should be with the independents. That is the underlying reason for that provision.

Now, if I may take a second on the recurrent promotions. I listened a good deal to the arguments on recurrent promotions and, curiously enough, if I may use this expression, everybody was trying to crash in on this idea of venture capital. The argument was: "Don't forbid recurrent promotions, because you will stop the capital market; you will ruin the country," and so forth.

Let us see how much there is to that argument. Is that the reason they are urging recurrent promotions, or is there some other reason? The fact of the matter is that Mr. Eberstadt wrote me a letter and said that every company should be an open-end company but should not have senior securities. As a matter of fact, if one has an open-end company he cannot go into that type of activity—venture capital. Why? Because if he is going to make capital available to a small business and get an equity position, he does not have a listed security; he does not have a marketable security; but he has an illiquid block of stock. The open-end company cannot put itself, to any substantial extent, in that type of stock because if there are redemptions the company cannot liquidate the illiquid block of stock to raise cash to meet the redemptions. So the fact is—and this is not theory—that every open-end company practically has every dollar of its money invested in the blue chips on the New York Stock Exchange. United States Steel and the American Telephone Co. are not looking for an investment company to finance them. If an investment company is going to perform the function of supplying a small industry with capital, the investment company cannot be an open-end company; that is clear.

Furthermore, this venture capital is not as simple as it looks, because, as Mr. Bunker will tell you, it requires a special type of training. It is not the same type of training as is required for trading in securities. You have to have special research facilities; and, further than that, the number of situations where an investment trust can invest are comparatively limited.

So that all this emphasis on organizing new investment companies to open up the capital markets makes no impression on me at all, because I am convinced, and I think everybody else is convinced, that it is only closed-end companies that can engage in that type of activity. However, under this bill open-end companies as well as the closed-end type of company can go into that type of transaction. Even a diversified investment company can use 15 percent of its money as venture capital.

In some respects the technique of the industry used in connection with recurrent promotions represents the technique throughout their entire presentation. They take the extreme case and say that "The prohibition against recurrent promotions will prevent me from organizing a venture capital organization. Therefore take the provision on recurrent promotions out."

This bill does not prevent the formation of any new companies. If anybody wishes to organize a venture capital company all he has to do is to make application with the Commission and, if there are no conflicts with the existing company and if the new company complies with the specific standard set forth in the statute, he can organize the new company. What we are trying to prevent is the organizing of companies just to be able to manufacture securities which they can sell.

Just one more observation. There was one gentleman who was asked, "Why have you senior securities in your capital structure?" He said, "If I didn't have senior securities, I am exactly like State Street, and I can't meet State Street's competition. State Street has had such a good performance that I have to have a type of security I can sell."

So he organized an open-end company with debentures in its capital structure, so he could sell the debentures. He also is able to say, "You can get leverage in my open-end company."

I would like to introduce for the record a schedule of the number of companies which were organized by one sponsor, and also a schedule showing the cost to the American public of switches from one company that was organized to another company organized by the same sponsor, and into still another company organized by the same sponsor. Ultimately, his whole investment is practically taken from him through these loads. That is the problem with which you are confronted. That is the problem that that section is intended to deal with. If anybody wants to organize a venture capital corporation he will have no difficulty in that respect.

May I introduce this for the record, please?

Senator HUGHES (presiding). Yes; it may go into the record.

(The document referred to is here printed in full as follows:)

SECTION 11. RECURRENT PROMOTIONS

There are two types of problems: (1) the concentration on distribution to the prejudice of management; and (2) the conflicting positions of sponsors of more than one trust. The first situation has been particularly prevalent among the fixed trust—open-end sponsors—the second among the closed-end sponsors as well as the fixed trust—open-end sponsors.

THE OPEN-END—FIXED TRUST SPONSORS

The total sales of all fixed trusts from 1927 to 1935 was over $900,000,000. Of the $900,000,000 or more of sales, about $760,000,000 were made by six sponsors.

TABLE 6.—*Total sales of leading sponsors as of December 31, 1935*

Calvin Bullock:	
Fixed trusts:	
Nation-Wide Securities Co. trust certificates, series A (1924)	$3, 279, 377
United States Electric Light & Power Shares, Inc., trust certificates, series A (1927)	58, 313, 822
United States Electric Light & Power Shares, Inc., trust certificates, series B (1930)	47, 965, 802
Nation-Wide Securities Co. trust certificates, series B (1930)	25, 132, 108
Total	$134, 691, 109

TABLE 6.—*Total sales of leading sponsors as of December 31, 1935*—Continued

Calvin Bullock—Continued.	
Management investment companies:	
Bullock Fund, Ltd. (1932)	$2, 495, 000
International Superpower Corporation (1928)	15, 865, 325
Carriers and General Corporation (1929)	21, 390, 000
Bullock Fund, Ltd. (new) (1932)	2, 354, 000
Canadian Investment Fund, Ltd. (1932)	3, 428, 885
Nation-Wide Securities Co. (Maryland) (1932)	9, 186, 996
United States Electric Light & Power Shares, Inc. (Maryland) (1932)	(1)
Dividend Shares, Inc. (1932)	30, 103, 755
Total	84, 823, 961
Distributors Group, Inc.:	
Fixed trusts:	
North American Trust shares, 1953 (1929)	184, 891, 572
Cumulative Trust shares (1930)	13, 104, 788
North American Trust shares, 1955 (1931)	28, 493, 077
North American Trust shares, 1956 (1931)	30, 469, 262
North American Trust shares, 1958 (1933)	950, 540
Total	257, 909, 239
Management investment companies:	
North American Bond Trust (1932)	9, 415, 889
Group Securities, Inc. (1933)	5, 800, 000
Foreign Bond Associates, Inc. (1933)	280, 000
Total	15, 495, 889
Massachusetts Distributors, Inc.:	
Fixed trusts:	
Industrial trustee shares (1924)	(1)
Diversified trustee shares (1925)	10, 322, 635
Diversified trustee shares, series B (1927)	16, 104, 196
Diversified trustee shares, series C (1929)	40, 331, 571
Diversified trustee shares, series D (1931)	12, 516, 401
Total	79, 274, 803
Management investment companies:	
Massachusetts Investors Trust (1924)	77, 204, 553
Supervised Shares, Inc. (1932)	10, 204, 553
Total	87, 409, 106
Maryland Sponsors, Inc.:	
Fixed trusts:	
Fixed trust shares (1927)	9, 824, 876
Basic industry shares (1928)	6, 507, 103
Fixed trust shares, series B (1929)	2, 274, 966
Fixed trust oil shares (1930)	299, 430
Corporate trust shares (1929)	144, 995, 823
5-year fixed trust shares (1931)	1, 695, 641
Corporate trust shares, accumulative servies (1931)	19, 019, 311
Corporate trust shares, series AA (1931)	15, 891, 624
Corporate trust shares, accumulative series (Modified) (1932)	12, 194, 122
Corporate trust shares, series AA (modified) (1932)	10, 464, 524
Total	223, 167, 420
Deduct for modified shares	19, 804, 639
Total	203, 362, 781

[1] Unknown.

TABLE 6.—*Total sales of leading sponsors as of December 31, 1935*—Continued

Maryland Sponsors, Inc.—Continued.	
Management investment companies:	
Quarterly Income Shares, Inc. (1932)	$35, 857, 000
The Maryland Fund, Inc. (1934)	4, 838, 000
Total	40, 695, 000
Super-Corporations of America Depositors, Inc.:	
Fixed trusts:	
Super-Corporations of America Trust shares:	
Series A (1930)	29, 790, 261
Series B (1930)	14, 155, 290
Series C (1931)	2, 834, 303
Series D (1931)	2, 803, 745
Series AA (1932)	5, 996, 374
Series BB (1932)	2, 773, 140
Total	58, 353, 113
Management investment companies (sponsored by Lord, Abbett & Co., Inc.):	
American Business Shares, Inc. (1932)	3, 916, 325
Affiliated Fund, Inc. (1934)	1, 491, 449
Total	5, 407, 744
Transcontinent Shares Corporation (formerly Bank and Insurance Shares, Inc.):	
Fixed trusts:	
Deposited bank shares, series B-1 (1928)	$2, 522, 123
Deposited bank shares, series N. Y. (1929)	4, 665, 054
Deposited insurance shares, series A (1930)	8, 882, 231
Deposited bank shares, N. Y., series A (1930)	9, 185, 829
Deposited insurance shares, series B (1935)	[2] 17, 000
Total	25, 272, 237
Installment investment plans (cash paid in):	
Insurance stock plan certificates (1932)	262, 740
New York bank stock contract plan certificates (1932)	110, 945
Total	373, 685
Total sales of fixed trusts as of Dec. 31, 1935	758, 863, 282

[2] Estimated.

EXCHANGE OFFERS TO HOLDERS OF FIXED TRUST SHARES

The following table contains data relating to exchange offers made to the holders of certificates for shares of the fixed trusts for which replies to the Commission's questionnaire were filed.

The material set forth herein was taken from the replies to the Commission's questionnaires for the trusts named.

Reported Exchange Offers to Holders of Fixed Trust Shares, 1927–35

[Trusts with distribution of $500,000 or over]

Name of trust	Number of shares exchanged	Approximate dollar value of shares exchanged	Original date of offer	Date of expiration of offer	Security offered in exchange	Premium allowed on shares submitted for exchange	Load on shares offered in exchange
Diversified Trustee Shares, Original Series.	953,105	$4,167,463	Apr. 22, 1932	Apr. 1, 1933	Diversified Trustee Shares, Series D.	20 cents per share	8.46 percent of offering price.
Diversified Trustee Shares, Series B.			Apr. 18, 1932	June 15, 1932	do	do	Do.
Do			June 15, 1932	Mar. 31, 1933	do	do	Do.
Do			Mar. 31, 1933	Sept. 19, 1933	do	do	Do.
Do			Sept. 19, 1933		Diversified Trustee Shares, Series D, or Supervised Shares, Inc.	do	Do.
Diversified Trustee Shares, Series C.			May 1, 1931	June 17, 1931	Diversified Trustee Shares, Series D.	None	None.
Do			June 17, 1931	Oct. 23, 1931	do	5 percent discount on new shares.	7½ percent of offering price.
Do			Oct. 23, 1931	Feb. 1, 1932	do	do	8.46 percent of offering price.
Do			Feb. 1, 1932	June 30, 1933	do	3 percent discount on new shares.	Do.
United States Electric Light & Power Shares, Inc., Trust Certificates, Series B.	764,000	1,715,000	June 18, 1934	Aug. 15, 1934	Nation-Wide Securities Co. (Md.).	3 percent of liquidating value.	9½ percent of liquidating value.
Nation-Wide Securities Co. Trust Certificates:							
Series A	3,980	30,000	Jan. 18, 1934	do	do	do	Do.
Series B	693,000	2,456,500	do	do	do	do	Do.
United States Electric Light & Power Shares, Inc., Trust Certificates, Series A.	458,000	580,000	do	do	do	do	Do.
Fixed Trust Shares	44,665	359,000	Jan. 16, 1933	Feb. 28, 1935	Quarterly Income Shares, Inc.	Preferential-bid (amount not stated).	Do.
Fixed Trust Shares, Series B	19,155	124,000	do	do	do	do	Do.
Basic Industry Shares	13,400	399,000	Jan. 14, 1933	do	do	do	Do.
Corporate Trust Shares, Original Series.	9,037,740	26,891,000	Nov. 19, 1931	June 15, 1932	Corporate Trust Shares, Accumulative Series or Series AA.	$0.125 per share to Mar. 15, 1932. $0.10 per share to June 15, 1932.	9½ percent of cost of property.
Do	2,741,000	1,556,280	Sept. 29, 1932	Nov. 25, 1932	Corporate Trust Shares, Accumulative (Modified), or Series AA (Modified).	$0.03 to $0.10 per share	Do.
Do	318,330	640,000	Jan. 23, 1933	Feb. 28, 1935	Quarterly Income Shares, Inc.	Preferential-bid (amount not stated).	Do.

Corporate Trust Shares:							
Series AA	654,465	1,233,000	do	do	do	Preferential-bid (2 cents per share average).	Do.
Series AA (Modified)	2,782,000	5,981,000	do	do	do	do	Do.
Accumulative Series	673,595	1,274,000	do	do	do	do	Do.
Accumulative Series (Modified).	2,748,000	6,010,000	do	do	do	do	Do.
5-Year Fixed Trust Shares	63,800	206,000	do	do	do	Preferential-bid (5 cents per share average).	Do.
Deposited Bank Shares:							
Series N. Y	104,000	290,000	Late in 1931	December 1935.	Deposited Bank Shares N. Y., Series A.	Small variable premium	8 percent of offering price.
Series B-1	33,000	101,000	December 1931.	do	do	do	Do.
North American Trust Shares, 1953.	16,000,000 to 18,000,000	32,000,000 to 36,000,000	Nov. 5, 1931	May 16, 1932	North American Trust Shares, 1955; North American Trust Shares, 1956.	$0.125 per share to Dec. 31, 1931; $0.10 per share to May 16, 1932.	9½ percent of cost of property.
Cumulative Trust Shares	6,275	23,081	Apr. 14, 1934	Dec. 31, 1935	Group Securities, Inc	2¾ percent to 4⅜ percent of asset value of Group Securities, Inc.	8¾ percent of asset value.
North American Trust Shares:							
1955	228,395	505,287	do	do	do	2¾ percent to 4⅜ percent of asset value of Group Securities, Inc.	Do.
1956	412,528	923,033	do	do	do	do	Do.
1958	218,810	560,116	do	do	do	2¾ percent to 4⅜ percent of asset value of Group Securities, Inc.	6¼ percent of asset value.
Super-Corporations of America Trust Shares:							
Series A	31,620	120,524	Nov. 6, 1935	Nov. 14, 1935	American Business Shares	7 cents per share	9½ percent of net asset value.
			Nov. 23, 1935	Dec. 17, 1935	do	13 cents per share	Do.
Series B	17,025	68,429	Nov. 6, 1935	Nov. 14, 1935	American Business Shares	3 cents per share	Do.
			Nov. 23, 1935	Dec. 17, 1935	do	9 cents per share	Do.
Series C	4,375	31,793	Nov. 6, 1935	Nov. 14, 1935	American Business Shares	5 cents per share	Do.
			Nov. 23, 1935	Dec. 17, 1935	do	17 cents per share	Do.
Series D	7,865	57,373	Nov. 6, 1935	Nov. 14, 1935	do	7 cents per share	Do.
			Nov. 23, 1935	Dec. 17, 1935	do	19 cents per share	Do.
Series AA	89,956	238,659	Nov. 6, 1935	Nov. 14, 1935	American Business Shares	4 cents per share	Do.
			Nov. 23, 1935	Dec. 7, 1935	do	8 cents per share	Do.
Series BB	52,350	140,107	Nov. 6, 1935	Nov. 14, 1935	do	6 cents per share	Do.
			Nov. 23, 1935	Dec. 17, 1935	do	10 cents per share	Do.
Fundamental Trust Shares:							
Series A	75,620	374,775	Aug. 1, 1935	Nov. 30, 1935	Fundamental Investors, Inc.	5 percent over bid price	8½ percent of asset value.
Series B	37,710	179,530	do	do	do	do	Do.

Reported Exchange Offers to Holders of Fixed Trust Shares, 1927–35—Continued

Name of trust	Number of shares exchanged	Approximate dollar value of shares exchanged	Original date of offer	Date of expiration of offer	Security offered in exchange	Premium allowed on shares submitted for exchange	Load on shares offered in exchange
Trust Shares of America	(1)	$350,000	September 1933.	January 1934.	Dividend Shares, Inc.	None	About 8 percent of asset value.
Trusteed New York Bank Shares.	(1)	(1)	Nov. 16, 1932	Dec. 31, 1932	Trusteed New York City Bank Stocks.	do	Not known.
Investors Trustee Shares, Series A.	(1)	100,000	1931	1931	American Composite Trust Shares.	do	8 percent to 9 percent.
Selected Cumulative Shares	(1)	(1)	Unlimited offer.	Unlimited offer.	Selected American Shares,	do	9 percent.

[1] Not available.

These 6 sponsors made 33 offers of exchange, either from one fixed trust into another, or from a fixed trust into an open-end management investment company. The dollar value of these exchanges was over $90,000,000 to the end of 1935, for which investors paid gross loading charges of about $5,000,000. Of the $90,000,000 of shares exchanged, $67,000,000 represented exchanges from one fixed trust into another and $23,000,000 represented exchanges into open-end companies.

If these figures be made to include exchange offers by competitors, and projected to the total fixed trust sales it may be estimated that about $120,000,000 of fixed trust shares were exchanged either for other fixed trusts or open-end companies at a cost (gross loading charges) to applicable investors of at least $6,700,000. Since these investors had already been subjected to at least one previous loading charge, they had already paid at least $12,000,000, on their investment or a total contribution to sponsors, for which they received nothing but the privilege of making these successive investments, of $18,700,000.

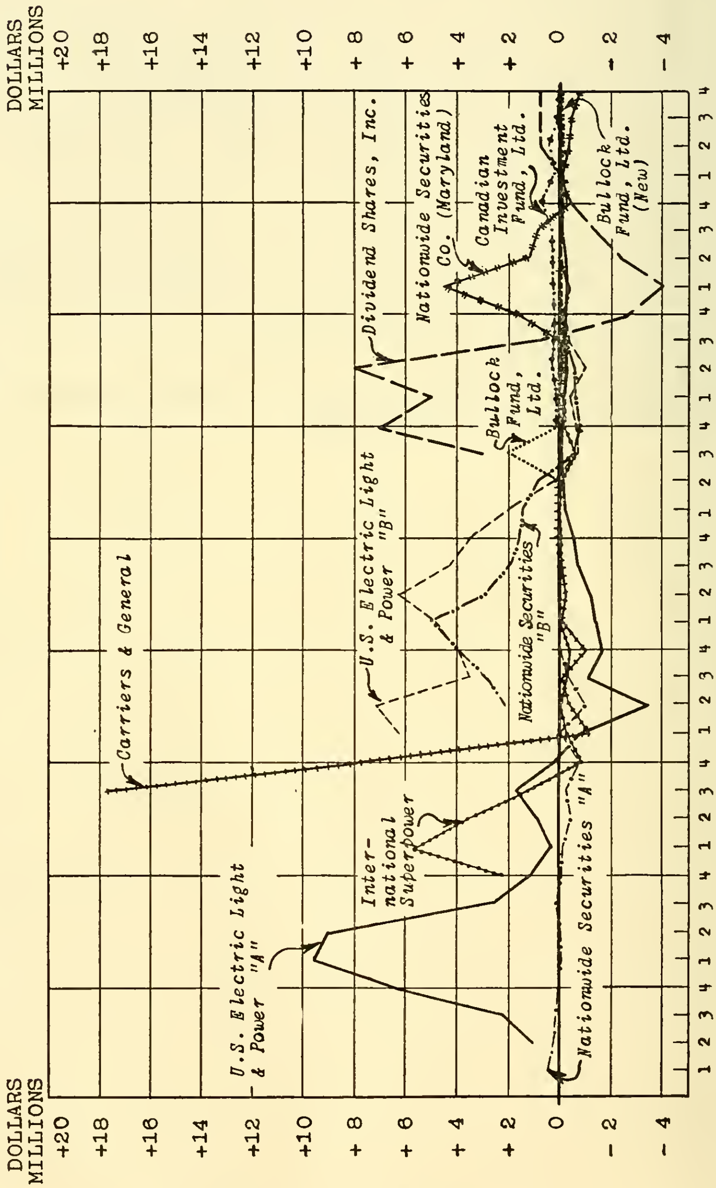
A graph showing the recurrent promotions—the "new model system"—of Calvin Bullock is shown on page 958.

Further figures may be cited as to the fixed trusts. Of the total sales of about $760,000,000 by the 6 sponsors, the value of the shares outstanding at the end of 1938 was about $44,000,000—less than 6 percent of the total sold. This difference, while it reflects the effect of general market decline and of redemptions by holders, also reflects the effect of exchanges, loading charges, disadvantageous sales by holders through over-the-counter dealers and the like.

The detail of various exchange offers by leading sponsors will be found in the Fixed Trust Report, pages 212–227.

The following tables indicate that the practice of multiple sponsorship was not confined to the open-end and fixed-trust fields.

NET SALES OF INVESTMENT COMPANIES IN BULLOCK GROUP



Excludes Electric Light & Power Shares, Inc. (Md.)
Organized June 1932, Max. Assets less than $500,000

Table showing chronological promotions and affiliations of investment companies by sponsor groups

LEHMAN BROTHERS

Date of promotion or affiliation	Contributed capital or approximate size at first of year end	Name of investment company	Genesis of affiliation	Period of affiliation	Change of status or present condition	Approximate present size or at change of status
Jan. 25, 1927	Dec. 31, 1927 $10,836,000	General American Investors Co., Inc.	Copromoters with Lazard Freres	Jan. 25, 1927–Aug. 5, 1929.	Merged with Second General American American Investors Co., Inc., on Sept. 5, 1929.	June 30, 1939 $19,402,000
Oct. 15, 1928	June 30, 1929 $18,322,000	Second General American Investors, Inc.	do	Oct. 15, 1928	Name changed to General American Investors Co., Inc., on Sept. 5, 1929.	Dec. 31, 1939 $26,475,000
Sept. 11, 1929	Dec. 31, 1929 $100,382,652	The Lehman Corporation	Sole promoters and sponsor	Sept. 11, 1929	do	Aug. 30, 1939 $67,357,000

Table showing chronological promotions and affiliations of investment companies by sponsor groups

NATIONAL INVESTORS GROUP

Date of promotion or affiliation	Contributed capital or approximate size at first year end	Name of investment company	Genesis of affiliation	Period of affiliation	Change of status or present condition	Approximate present size or at change of status
June 16, 1927	$4,400,000 (paid-in).	National Investors Corporation	Organized and managed by Presley. Underwriters were Guardian Detroit Co., Inc., and Shawmut Corporation of Boston.	June 16, 1927–Apr. 1, 1937.	Consolidated with Second, Third, and Fourth National Investors Corporations to form a new National Investors Corporation.	$4,737,000 (Apr. 1, 1937).
Nov. 9, 1928	$10,600,000 (paid-in).	Second National Investors Corporation.	Organized and managed by National Investors. Underwriters were Guardian Detroit Co., Inc., and Shawmut Corporation of Boston. National Investors purchased 100,000 shares of common and 200,000 warrants for $1,000,000.	Nov. 9, 1928–Apr. 1, 1937.	Consolidated with other 3 National Investors Corporations to form a new national investors corporation. Management contract terminated at end of 1934 but another entered into March 1936 to April 1937.	$6,902,000 (Apr. 1, 1937).
Feb. 27, 1929	$10,400,000 (paid-in).	Third National Investors Corporation.	Organized and managed by National Investors Corporation. Underwriters were Guardian Detroit Co. and Shawmut Corporation. National Investors paid $1,000,000 for 20,000 common shares and option warrants to purchase 130,000 common shares.	Feb. 27, 1929–Apr. 1, 1937.	Same as Second National Investors	$6,544,000 (Apr. 1 1937).
Aug. 13, 1929	$27,000,000	Fourth National Investors Corporation.	Organized and managed by National Investors Corporation. Underwriters were Guardian Detroit Co. and Shawmut Corporation of Boston, Marine Trust Co. (Buffalo) and N. W. Harris Co. (Chicago). National Investors paid $3,000,000 for 750,000 common stock option warrants.	Aug. 13, 1929–Apr. 1, 1937.	do	$23,831,000 (Apr. 1, 1937).
Apr. 1, 1937	$30,864,000 (gross assets, Apr. 1, 1937).	National Investors Corporation (a Maryland corporation).	This company is the result of the consolidation of the 4 preceding corporations.	Apr. 1, 1937, to date.	No change	$14,937,000 (Dec. 31, 1939).

Investment companies organized by Jonathan B. Lovelace

Date of affiliation	Name of investment company	Contributed capital	Genesis of affiliation	Period of affiliation	Change of status or present condition	Size at change of status or at present
Mar. 1926	The Investment Company of America.	$13,832,000 (paid-in at end of 1930).	Organized by Lovelace and E. E. MacCrone & Co. Lovelace supplied investment advisory service through Investment Research Corporation. E. E. MacCrone was underwriter and broker. Bonbright & Co. underwrote the issue of debentures.	March 1926 to date.	The original company was The Investment Trust of America, a common law trust administered by a Michigan trustee corporation. The name was changed to the Investment Co. of America in October 1926. The present company was incorporated in Delaware in August 1933 to carry out a plan of capital readjustment of the predecessor trust. In December 1938, the company amended its certificate of incorporation to provide for the repurchase of its shares at 92½ percent of net asset value. At end of 1939, Pacific Southern Investors, Inc. held 39 percent of outstanding stock.	$4,412,000 (gross assets at Dec. 31, 1939).
April 1927	Pacific Investing Corporation.	$13,411,000 (paid-in at end of 1930).	Organized and managed by Lovelace and a group of Los Angeles business men. Securities underwritten by Blythe, Witter & Co.	April 1927–April 1932.	Merged into Southern Bond & Share Corporation to form Pacific Southern Investors, Inc.	$4,541,000 (gross assets at Apr. 25, 1932).
May 1928	American Capital Corporation.	$13,153,000 (paid-in).	Organized and managed by Lovelace and a group of Los Angeles businessmen. Securities underwritten by Bonbright & Co.	May 1928 to date.	At end of 1939, Pacific Southern Investors, Inc., held 28 percent of preferred, 13 percent of class A, common, and 12 percent of class B common.	$5,682,000 (gross assets at Dec. 31, 1939).
July 1928	Southern Bond & Share Corporation.	$3,120,000 (paid-in).	Organized and managed by Lovelace. E. E. MacCrone & Co. was principal underwriter.	July 1928–April 1932.	Merged with Pacific Investing Corporation to form Pacific Southern Investors, Inc.	$1,414,000 (gross assets less treasury stock at Apr. 25, 1932).
April 1932	Pacific Southern Investors, Inc.	$5,944,000 (gross assets at organization).	Result of merger of Pacific Investing Corporation and Southern Bond & Share Corporation.	April 1932 to date.	No change	$7,556,000 (gross assets at Dec. 31, 1939).

Table showing chronological promotions and affiliations of investment companies by sponsor groups

FIELD, GLORE & CO.

Date of promotion or affiliation	Contributed capital or approximate size at first year end	Name of investment company	Genesis of affiliation	Period of affiliation	Change of status or present condition	Approximate present size or at change of status
Aug. 3, 1927	$16,296,000 (paid-in).	Chicago Investors Corporation	Organizers, principal underwriters, managers and brokers.	1927–32	Merged into Continental Chicago Corporation Dec. 20, 1932 when name of latter changed to The Chicago Corporation.	$4,098,000 at Nov. 14, 1932.
January 1928	$24,250,000 (paid-in).	Italian Superpower Corporation	Organizers and underwriters with Bonbright & Co.	1928 to date	American Superpower Corporation acquired 50 percent voting stock interest in 1929 which was sold in 1930 to Atlas Corporation.	$31,096,000 (Dec. 31, 1939, gross assets).
November 1928.	$3,000,000 (paid-in).	Aviation Securities Corporation	One of organizers and underwriters	1928–31	Atlas Corporation acquired majority control in December 1931 through Chatham Phenix Allied Corporation after purchasing warrants from sponsors. Corporation was dissolved in October 1933.	$1,725,000 (Dec. 31, 1931) (gross assets)
January 1929	$3,000,000 (paid-in).	Tobacco and Allied Stocks, Inc.	do	1929–to date	No change	$4,997,000 (Dec. 31, 1939) (gross assets).
Feb. 9, 1929	$59,375,000 (paid-in).	Chicago Corporation (old)	Organizers, principal underwriters, managers, and brokers.	1929–30	Merged into Continental Chicago Corporation, Dec. 8, 1930.	$41,332,000 at Nov. 3, 1930.
Aug. 1, 1929	$4,500,000 (paid-in).	F. G. Trading Corporation	Organizers, distributors, managers and brokers. Successor to 38 Wall Street Trading Account.	1929–40	Liquidation plan accepted Dec. 13, 1939. Assets distributed Jan. 18, 1940.	$835,557 at Dec. 31, 1938.
Sept. 11, 1929	$63,750,000 (paid-in).	Continental Chicago Corporation.	Organized jointly by Field, Glore & Co. and Continental Illinois Co. Field, Glore & Co. also provided underwriting, management and brokerage facilities.	1929 to date	Name changed Dec. 20, 1932 to the Chicago Corporation.	$43,151,000 at Dec. 31, 1935.

Investment companies organized by Chas. D. Barney & Co. and the Reynolds Bros.

Date of affiliation	Name of investment company	Net paid-in capital	Genesis of affiliation	Period of affiliation	Change of status or present condition	Size at change of status or at present
May 1927	Investors Equity Co., Inc	$18,764,000 (paid-in).	Organized by Chas. D. Barney & Co., Reynolds Co., Inc., and others. Chas. D. Barney & Co. were underwriters.	May 1927–May 1932.	Assets sold to Tri-Continental Corporation and to Equity Shares, Inc.	$6,559,000 (assets at valuation of Tri-Continental and Equity Shares, Inc.).
March 1928	Reynolds Investing Co., Inc	$14,358,000 (paid-in, including paid-in capital of Reynolds Bros., Inc.).	Reynolds & Co. and Chas. D. Barney & Co. were the organizers, underwriters, and managers.	March 1928–December 1937.	Control sold to brokerage firm of Prentice & Brady who actually represented Continental Securities Corporation and the Fiscal Management Group.	$4,900,000 (net assets at Dec. 31, 1937).
December 1928	Selected Industries, Inc	82,349,000 (paid-in).	Organizers, managers, and distributors together with Stone & Webster and Blodgett, Lehman Bros., Kidder, Peabody & Co., and Brown Bros. & Co.	December 1928–May 1931.	Reynolds Bros. sold interests to Tri-Continental Corporation. Chas. D. Barney & Co. retained its holdings.	48,965,000 (June 30, 1931, gross assets).
February 1929	Reynolds Bros., Inc	6,500,000 (paid-in).	Organizers and managers. Chas. D. Barney & Co., sole underwriters.	February 1929–May 1930.	Company absorbed by Reynolds Investing Co., Inc. by exchange of shares.	6,548,000.
Do	The Reybarn Co., Inc	13,307,000 (paid-in).	Organizers, managers, underwriters, and brokers. After June 1932, managed solely by Chas. D. Barney & Co.	February 1929–October 1938.	Liquidated beginning October 1938	3,276.000 (Nov. 30, 1937, gross assets).

Investment companies promoted by the Founders Group

Date of affiliation	Name of company	Net paid-in capital	Genesis of affiliation	Period of affiliation	Change of status	Net assets at end	Net loss from operations
January 1922	American Founders Corporation (formerly Weeks, Lewis & Bull Co. and American Founders Trust).	$112,447,000	Organizers and managers	January 1922–July 1933.	Control transferred to The Equity corporation through United Founders Corporation consolidated into American General Corporation in November 1935.	$17,109,000 (Nov. 23, 1935).	$83,957,000.
Do	International Securities Corporation of America (formerly International Securities Trust of America).	$64,249,000	Organizers and managers. Securities distributed by Harris, Forbes & Co.	do	Same as American Founders Corporation.	$18,411,000 (Nov. 23, 1935).	$21,162,000.
October 1926	Second International Securities Corporation.	$22,337,000	Organizers and managers. Securities distributed by American Founders Corporation.	October 1926–July 1933.	do	7,249,000 (Nov. 23, 1935).	$8,612,000.
January 1928	United States & British International Co., Ltd.	$16,625,000	Organizers and managers. Distributors were Pogue-Willard & Co., Helbert Wagg & Co., Ltd. (British), Ames, Emerich & Co., Tucker, Anthony & Co., and Harris, Forbes & Co.	January 1928–July 1933.	do	3,334,000 (Nov. 23, 1935).	$9,263,000.
February 1928	Founders General, Corporation.	$7,575,000	Wholly owned subsidiary of American Founders Corporation to distribute the securities of the group.	February 1928–July 1933.	do	49,000 (Nov. 23, 1935).	$2,108,000 (profit).
October 1928	American & General Securities Corporation.	$17,000,000	Organizers and managers. American Founders subscribed for all the stock issued and headed the distributing syndicate.	October 1928–July 1933.	do	6,235,000 (Nov. 23, 1935).	$7,563,000.
October 1928	Investment Trust Associates.	$13, 000, 000	Acquired by American Founders Corporation from Combs & Bull.	October 1928–June 1931.	Liquidated and absorbed by United Founders Corporation.	$7,107,000 (June 30, 1931).	$5,083,000.
February 1929	Founders Associates	$578, 000	Organizers and managers	February 1929–July 1933.	Control transferred to The Equity Corporation through United Founders Corporation. Liquidated November 1935.	$174,000 (Nov. 15, 1935).	$278,000.
Do.	United Founders Corporation.	$300, 866, 000	do	do	Control transferred to The Equity Corporation. Consolidated into American General Corporation in November 1935.	$15,348,000	$285,443,000.

July 1929	American and Continental Corporation.	$17,956,000 ($9,956,000 under former sponsor).	Company organized in 1924. American Founders Corporation acquired control, distributed securities and acted as co-manager.	July 1929'July 1933.	Same as American Founders Corporation.	$8,599,000	$2,072,000.
September 1929	United States Electric Power Corporation.	$149,650,000	Co-promoters and managers with Victor Emanuel, Hydro-Electric Securities Corporation, A. C. Allyn & Co., and The Harris Forbes Corporation.	September 1929 – July 1936.	Control transferred to The Equity Corporation in 1933 through United Founders Corporation Liquidated November 1936 at which time no assets remained.	None at November 1936.	142,861,000.
Jan. 1929	United States and Overseas Corporation.	$22, 200, 000	Organizers with Harris, Forbes & Co., N. W. Harris & Co., and others. Control acquired by General Investment Corporation in October 1930.	Jan. 1929–July 1933.	Control transferred to The Equity Corporation through United Founders Corporation. Liquidated in May 1934 by exchange of its assets for shares held by General Investment Corporation.	$20,966,000 (Nov. 30, 1930).	$2,741,000 (through Nov. 1934).
Sept. 1929	General Investment Corporation. (Formerly The Public Utility Holding Corporation of America.	$78, 634, 000	Organizers with The Harris Forbes Corporation.	do	Control transferred to International Equities Corporation in August 1936 by American General Corporation, successor to Founders group.	5,400,000 (May 1936).	$70,604,000 (through May 1936).

Investment companies sponsored by J. & W. Seligman & Co.

Date of promotion or affiliation	Name of investment company	Contributed capital or approximate size	Genesis of affiliation	Period of affiliation	Change of status or present condition	Approximate present size or at change of status
Jan. 4, 1929	Tri-Continental Corporation (old Tri-Continental).	$51,767,000 (Feb. 11, 1929).	Organizers and sponsors. At end of 1929, 6 of 16 directors were members of Seligman. Seligman was sole underwriter.	Jan. 4, 1929–Dec. 31, 1929.	Consolidated with Tri-Continental Allied Company, Inc. to form new Tri-Continental Corporation on Dec. 31, 1929.	$40,156,000 (Dec. 31, 1929).
Aug. 15, 1929	Tri-Continental Allied Co., Inc.	$50,432,000 (Aug. 29, 1929).	Organizer, together with old Tri-Continental. Old Tri-Continental provided the management for Tri-Continental Allied. Same board of directors.	Aug. 15, 1929–Dec 31, 1929.	Consolidated with old Tri-Continental Corporation to form new Tri-Continental Corporation on Dec. 31, 1929.	$ 36,747,000 (Dec. 31, 1929).
Dec. 31, 1929	Tri-Continental Corporation (new Tri-Continental).	$75,925,000 (Jan. 1, 1930).	Organizer. Investment adviser (without compensation until Apr. 12, 1938); supervised and assisted in the management; made 6 persons available as directors, 3 of whom could serve as officers (4 directors at end of 1939 were partners of J. & W. Seligman); acted as brokers; acted as custodian and dividend disbursing agent.	Dec. 31, 1929, to date.	Service agreement between Tri-Continental Corporation and J. & W. Seligman modified Apr. 12, 1938, to provide for compensation to directors and officers appointed by Seligman and granted right to Seligman to assign the service agreement.	$33,051,000 (Dec. 31, 1939).
Jan. 27, 1931	York Share Corporation	$131,000 (Dec. 31, 1931).	Organized by J. & W. Seligman who was also sole underwriter. Held all voting stock.	Jan. 27, 1931–Oct. 1932–Feb. 1933.	Shares of York Share Corporation exchanged in October 1932 for shares of Broad Street Investing Company, Inc., York Share Corporation was liquidated in February 1933.	$64,000 (October 1932).

Mr. SCHENKER. In connection with section 12 there was not much discussion except, as I recall it, Mr. Quinn urged that there ought to be a first degree holding company investment trust.

We say that there is no economic function performed by piling one investment company on another. You get this situation: A person may be paying the management fee in "A" company and paying part of the management fee in "B" company. You get the most complicated capital structures. I would like to read you the pages and pages of description of the rights and duties of the security holders in the Central States Electric situation. I doubt if anybody could figure out what his rights are when you consider that one company is piled on another. I will not elaborate on that subject, but I think the record ought to show the various complications you can get when you start piling one investment company on another. We should like to introduce a series of charts showing the pyramided structures of investment companies in existence as at December 31, 1939. The chart showing the present status of the Tri-Continental Corporation group of companies is found in part I, p. 280 of Senate Hearings on Investment Trusts and Investment Companies.

Senator HUGHES (presiding). The charts will be received.

(The charts referred to and submitted by Mr. Schenker are printed in part 3 of the hearings.)

Mr. HEALY. If the committee please, I would like to offer a compilation of statutory provisions respecting dividends, taken from the 1939 Corporation Manual.

Senator HUGHES. That is interesting.

Mr. HEALY. I suggest that perhaps it does not need to be printed.

Senator HUGHES. It is very short. It might be included in the record.

(The document referred to and submitted by Mr. Healy is as follows:)

STATUTORY PROVISIONS RESPECTING DIVIDENDS FROM 1939 CORPORATION MANUAL

Alabama.—No provision.

Arizona.—From surplus profits arising from business of corporation.

Arkansas.—From net earnings or the surplus of its assets over its liabilities, including capital.

California.—From (1) earned surplus, or (2) net profits earned during preceding period of not less than 6 nor more than 12 months, even though net assets are less than stated value, provided, however, that preference stocks are not impaired and (3) paid in surplus or reduction surplus, on preference shares only. Dividends may not be paid out of unrealized profits or surplus, nor which would render the corporation insolvent. Specific provisions for share dividends.

Colorado.—No dividends while corporation is insolvent or which would render it insolvent or impair its capital.

Connecticut.—From net profits or "actual" surplus, but which will not render corporation insolvent or impair capital.

Delaware.—Out of net assets in excess of capital stock, or in case there are none, out of net profits from the current and/or preceding fiscal year, provided preference stocks are not impaired.

District of Columbia.—Same as Colorado.

Florida.—Same as Arkansas, but not while corporation is insolvent or which would render it insolvent.

Georgia.—Same as Delaware.

Idaho.—From any surplus except that arising from unrealized appreciation in value or revaluation of fixed assets. Stock dividends may be paid from any surplus.

Illinois.—No dividends when corporation is insolvent or net assets less than stated capital, or when payment of dividend would cause such conditions. No

dividends out of paid-in surplus except on preferred stock, nor out of unrealized appreciation or revaluation surplus except stock dividends. Special provisions as to stock dividends.

Indiana.—From surplus earnings or net profits or surplus paid in in cash. Stock dividends only may be paid from unrealized appreciation or revaluation surplus.

Iowa.—Same as Colorado.

Kansas.—Only from profits and not while insolvent or which would thereby be rendered insolvent.

Kentucky.—Same as Colorado.

Louisiana.—From surplus except unrealized appreciation surplus or unrealized profits. Must give notice if out of paid-in surplus. Stock dividends from any surplus.

Maine.—No dividends if capital is thereby reduced, until all debts due from corporation are paid.

Maryland.—No dividends when corporation is insolvent or would become so or would diminish amount of capital stock; but a dividend from the surplus or the net profits of the corporation is determined in accordance with good accounting practices shall not be deemed to diminish amount of capital stock.

Massachusetts.—No dividend if corporation is, or thereby is rendered, bankrupt, or insolvent.

Michigan.—From earned surplus or net earnings except from unrealized appreciation or revaluation surplus. Dividends on preferred stock may be paid from any surplus, provided notice is given if paid from other than earned surplus. Special provisions as to stock dividends.

Minnesota.—From (1) earned surplus, (2) paid-in surplus, if accompanied by notice as to source, provided there are no preference shares, in which event only preferred dividends may be paid from paid-in surplus. (3) Earnings for the current year preceding fiscal year whether or not earned or paid-in surplus exists, provided there is no impairment of preference stocks or corporation's solvency. Unrealized appreciation of assets shall not be included as surplus for dividend purpose. Special provisions as to stock dividends.

Mississippi.—Same as Colorado.

Missouri.—Same as Colorado.

Montana.—Same as Arizona.

Nebraska.—From the profits of the business, not reducing capital while there are outstanding liabilities.

Nevada.—Same as Arkansas.

New Hampshire.—No dividend when property is insufficient or will thereby be rendered insufficient for payment of debts. Surplus profits may be capitalized by issuance of stock dividends.

New Jersey.—Same as Arkansas.

New Mexico.—Unless otherwise provided in charter or bylaw, directors each year shall declare a dividend of the whole of the accumulated profits over and above its capital stock plus such sum, if any, fixed by the stockholders.

New York.—No dividend which shall impair its capital, nor while it is impaired, nor unless the value of assets remaining shall be at least equal to the aggregate amount of debts and liabilities, including capital.

North Carolina.—Shall pay out each year all accumulated profit in excess of capital stock paid in plus whatever sum is fixed by stockholders; but no dividend shall be paid except from surplus or net profits or when its debts excees two-thirds its assets (three-fourths in case of public service corporation) or which will impair its capital.

North Dakota.—Same as Arizona.

Ohio.—Out of excess of aggregate of assets over agreegate of liabilities plus capital stock, but not including unrealized appreciation. No dividend when there is reasonable ground for believing that corporation is unable or will be rendered unable to satisfy its obligations and liabilities. If dividend is out of other than earned excess of assets appearing on the books of the corporation, shall be accompanied by notice as to its source.

Oklahoma.—Same as Arizona.

Oregon.—No dividend if insolvent or which would render it insolvent, or out of assets other than net profits or surplus.

Pennsylvania.—From surplus of the aggregate of assets over aggregate of liabilities including capital, but excluding from surplus unrealized appreciation or revaluation surplus. Out of paid-in surplus only on preferred stock and when accompanied by notice as to source. Special provision for stock dividends.

Rhode Island.—From surplus or net profits but capital not to be impaired.

South Carolina.—No dividends unless actually earned or paid out of surplus heretofore earned and not set aside for special purpose.

South Dakota.—Same as Arizona.

Tennessee.—From corporation's net earnings or from surplus of assets over liabilities including capital. Special provision for stock dividends.

Texas.—No dividends when corporation is insolvent or which would render it insolvent. Dividends to be paid out of the profits from the business.

Utah.—No dividends except from surplus profits or which would distribute capital.

Vermont.—No dividends may be paid out of capital.

Virginia.—Dividends out of net earnings, or out of net assets in excess of capital but which will not impair capital. Written notice must be given if paid out of contributed surplus. From surplus but not including unrealized appreciation or revaluation surplus. Special provisions for stock dividends.

Washington.—From surplus, but not including unrealized appreciation or revaluation surplus. Special provisions respecting stock dividends.

West Virginia.—Dividends payable out of net profits or reduction surplus, but not while corporation is insolvent or which would render it insolvent or diminish capital. Special provisions respecting stock dividends.

Wisconsin.—Out of net profits properly applicable thereto and which shall not impair or diminish capital, nor when corporation is insolvent or in danger of insolvency, but may pay dividends out of unrealized appreciation surplus.

Wyoming.—Same as Colorado.

Statutes of the following States make special provision for payment of dividends by wasting asset corporation.—Arkansas, California, Delaware, Georgia, Idaho, Indiana, Louisiana, Michigan, Minnesota, Ohio, Pennsylvania, Washington, and West Virginia.

Mr. HEALY. I would like to file a memorandum of the provisions of the bill relating to capital structure. It is information that is too long to try to reproduce in the record.

Senator HUGHES. It will be filed as an exhibit.

(The memorandum of provisions of the bill relating to capital structure, referred to, was filed with the committee.)

Mr. HEALY. If we may have an hour this afternoon I think we can close. Will that be possible?

Senator HUGHES. I do not know just what to say about that. I do not know what is being considered on the floor. Suppose we take a recess until half-past 2 and see what we can do.

Senator HERRING. Is it your idea that we can finish if we come back at 2:30?

Senator HUGHES. Yes; Mr. Bunker has asked permission to make a statement.

Senator HERRING. I am wondering whether it would not be better to file written statements instead of arguing back and forth. It seems to me that after the Commission finishes its presentation we can leave the matter open for 2 or 3 or 4 days or a reasonable time in which to file any statements they may wish to, and they may be printed in the record. There is such a small number of the members of the committee here, and the subcommittee must have a chance to read this record. You gain very little by reading your statements to one or two Senators.

Mr. BUNKER. I have a statement which is a closing statement for both sides of the industry. It will not take more than 15 or 20 minutes to present it.

Senator HUGHES. We will try to cover both sides this afternoon, beginning at 2:30.

Senator HERRING. We will leave the record open so that if anyone wishes to file a written statement it will be accepted.

(Whereupon, at 1 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTER RECESS

The subcommittee resumed at 2:30 p. m. on the expiration of the recess.

Senator HERRING (presiding). Any time you are ready, Judge Healy, you may go ahead. We will not wait for Senator Hughes, but I expect him in at any moment.

ADDITIONAL STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.—Resumed

Mr. SCHENKER. Senator Herring, I think the record ought to indicate that in the course of our presentation we did not furnish you with all the "horrible" examples that our investigation uncovered. The fact of the matter is, we did not even present, or tell you in detail, of all the numerous cases which are included in our reports already transmitted to the Congress, let alone the numerous cases in addition thereto.

For instance, we did not tell you about Oil & Industries, Inc., which was cleaned out similarly to Continental Securities Corporation, although it did not involve that amount of money.

We did not tell you the story of the Chatham Phenix Allied Corporation, where the officers and directors, in connection with their participation in the erection of the Empire State Building, borrowed $1,000,000 from the investment trust, and then the investment trust, in order to raise money to complete the building, was made to buy $6,000,000 of Empire State bonds. The investment company subsequently had to get out of these bonds with a $5,000,000 loss; and of the $1,000,000 loaned to the officers and directors there is still approximately $250,000 unpaid.

We did not tell you the story of Central Illinois Securities Corporation, connected with the Central Illinois bank.

We did not tell you the story of the companies acquired by Wallace Groves, other than his connection with G. I. C., where he got control of Interstate Equities, then Chain & General, and then Yosemite Holding Corporation. He came out with $1,000,000 profit, while the stockholders took the licking.

We did not tell you the story of the Petroleum Corporation of America, where in my opinion they raised $100,000,000 of the public's money, and every dollar of that money was used to try to effect a combination of Tidewater, Rio Grande, and Sinclair.

In connection with that company, in order to try to help effect that merger, the insiders bought a big block of Prairie Oil & Prairie Pipe stock from the Rockefeller trusts. Immediately these insiders started four accounts running, and ran the market price up about $6,000,000. They then sold this block to this investment trust, which was organized for that purpose. They then had the investment trust buy more Prairie Pipe & Oil stock.

In order to help effect the merger, they had an agreement whereby they agreed to buy $23,000,000 of Tidewater stock from the Standard Oil Co. They had the Petroleum Corporation of America and Interstate Equities, both dominated by the same banking firm, take a substantial commitment. These investment companies paid about $2,500,000 as part of the first payment on that contract. The market

price of Tidewater flopped so badly that the first payment was enough to pay for the whole block of stock. The wind-up was that these investment companies dropped their entire investment, and did not get a single share of Tidewater stock.

We did not tell you the story of the investment trust control of which was obtained by Kenyon. I think that is an excellent illustration that one can do the same thing with an open-end trust as with a closed-end trust. Kenyon got control of a few open-end companies and cleaned them out. He was not here to tell the story.

We did not tell the story of the Eastern Utilities Investing Corporation, an investment trust controlled by Hopson, where the company wound up with every dollar of their money in Associated Gas & Electric stock. In the end the investment company would up in the wringer in 1935 with practically no money. They started with $130,000,000.

We did not tell you of Utility & Industrial organized by Byllesby & Co. The investment company raised $30,000,000. Byllesby & Co. as principal sold $23,000,000 of securities to that company. The company wound up with approximately $2,000,000. Included in the $23,000,000 of securities sold by Byllesby to the investment company was the stock of the Federal Public Service Co., which went broke. They sold the investment company a waterworks down in Mexico, which in 2 years after it was sold, was confiscated by the Mexican Government. They sold the investment company about $1,000,000 of Deep Rock Oil Co. Mr. Justice Roberts' opinion in that case said the company was broke from its very inception. One of the directors of Standard Gas who appeared before us said that Deep Rock was only two steps ahead of the wolf at the time the stock was sold to the company.

In addition to that let us take the case of Charles V. Bobb, which is an excellent example of the necessity for legislation. He got control of several investment trusts and cleaned them out. They had to try him three times. Two juries disagreed—before they convicted him. He likewise raised the defense that the transaction was fair. If you have a provision that one cannot sell securities in those circumstances, fair or unfair, that would end it.

And we have example after example after example of that kind which we could show you. However, I think that point has been explored sufficiently by this time.

We have not developed to any extent the amount of loans that were made to officers and directors, but if you are interested we could give you some over-all figures.

We did not tell of the loans made by Unginleider Financial Corporation and by Insuranshares of Delaware to former Judge Manton. Remember, this was the people's money which was being disbursed. The only thing we are asking is that the safeguards be set up in order that this sort of thing shall not happen again.

Now, I would just like to discuss very, very briefly section 25 of the bill, which deals with reorganization of investment companies. You made a suggestion, Senator Herring, about the situation where a court has jurisdiction of the reorganization. Of course we have no difficulty with that suggestion. We think that is the sensible approach.

The situation that is disturbing is the one where there is no court to take a look at the plans. And this is not a small matter when you

consider that in the short period of time the investment trusts were in existence in this country there were over $800,000,000 of securities which were issued by investment companies in exchange for the other fellow's investment company securities. It was like printing their own money—they printed $800,000,000 of securities and exchanged them.

In those circumstances there was nobody there to advise the stockholder as to what the exchange offer really meant, whether he was getting a fair shake, or whether the plan was fair.

Now, what does our study show? You take in the case of the Atlas Corporation. They started out with a fairly small company and they grew to a substantial size. Their increase in assets was not due to the fact that they picked representative stocks which went up. Their increase in assets was by far due to the fact that they made exchanges with others, and got control of other investment trusts, and merged them into one big company.

Now, what was the technique used on these exchange offers made by various investment companies? The technique was substantially this: Investment company securities were selling at a discount in the market. Their market value was less than their asset value. What they did was this: After they had made a connection with these investment companies they made a series of exchange offers. These offers were almost uniformly like this: They gave a little more than the market value and a little less than the asset value. So that the money was made by buying the other fellow's dollar at 90 cents or 80 cents. They had these exchange offers which sometimes had one alternative or maybe two or three alternatives.

Now, the fact is that the ordinary investor is in no position to appraise the fairness of the exchange offer, particularly in view of the fact that the assets of a company may consist of situations which are appraisal situations. He is helpless.

But, further than that, he was not helped in the least by his own fiduciaries, by his own people, to whom he entrusted his money and who were supposed to manage it.

What was the technique used by the companies which made exchange offers? They would pay certain emoluments to the incumbent managers to recommend the exchange to their stockholders.

Now, what form did those payments take? In some instances just an out-and-out payment of cash. In one case they paid $200,000 to the management and then the management sent out a letter saying: "We recommend that you accept this exchange offer." And that was done without any disclosure that they were getting $200,000 for doing it.

Or, if there was no cash payment and if the management had option warrants which were not worth a dime, they would buy the option warrants and then the management would make the recommendation to the stockholders to accept the exchange offer. In some cases there was a disclosure of this purchase of the warrants.

If the incumbent management had a management contract on which they had not made a nickel in years, the persons seeking to obtain control would buy the contract. If a man had stock in the company they would pay him a big price for his stock, and then buy the stock of the other stockholders below its asset value. If the insider did not have stock, or option warrants, or a management

contract, or were not paid cash, what would the new interests do? They would say: If you help us in this exchange offer, then when you sever your connection with this company we will continue to give you the brokerage business.

What did that mean to the stockholder? That left the stockholder in this situation: Suppose he went to his own management and said: "They want to give me so many shares of the Atlas Corporation in exchange for my shares. Shall I take the offer?" In that case the stockholder could not get an unbiased opinion as to whether or not that offer was a fair exchange.

If the stockholder went around to the broker or to the banker he was confronted with this situation: That in connection with all these exchange offers, of Atlas, Equity, or Associated Gas and so forth, why, they used to pay brokers and bankers a commission on every offer accepted. He could not get any disinterested advice there; so there he was stymied.

All this bill says is where you have these exchange offers, they should be submitted to the S. E. C. and the S. E. C. should either approve or disapprove. I will talk about that approval or disapproval. You can take two approaches. You can say that the S. E. C. should not help the small investors—and the majority of the people holding only $500 worth of securities cannot go out and hire first-class lawyers and statisticians to advise them whether to accept this offer. You can also empower the Commission to make an advisory report or to approve voluntary reorganizations.

Let me take up the subject of the advisory report. Some statements were made here about trying to force upon a stockholder something that he might not want to take, or are preventing him from accepting something that he might want. That is not unusual. In connection with judicial reorganizations, regardless of the fact that the majority of the stockholders approve the plan, the Supreme Court of the United States said it is still necessary to find out whether the plan is equitable. The fact of the matter is that in the case of the merger of Alleghany and Chesapeake, the management had the requisite votes to put over the plan and yet Tri-Continental went into court to get a restraining order.

The purpose of section 25 is to fill in the gap where you do not have anyone to perform that function performed by the court.

You also have other difficulties. You find that the stockholder, in certain circumstances, does not have an appraisal right. If he dissents, that is all he can do about it; because, as I understand, under the Delaware law he does not have any appraisal right in certain cases.

Now, under the Delaware laws, if it takes the form of a sale of assets, he does not have an appraisal right. In connection with the voluntary recapitalization of the capital structure of the company, he does not have any appraisal right.

What happens? The people who own the common stock can really change the whole nature of the holding of the preferred stockholders, and affect their dividends, and so forth and so on. We think it is an important problem.

The fact of the matter is that Mr. Odlum himself, said quite frankly:

> I should like to add this for the record: That it is a poor man who does not gain knowledge as he grows older. I am some 7 years older today than I was

when we started this investment trust acquisition program, and there were many things we found in the way of technique, mechanics, and methods that, today, based on the experience, I would probably not do the same way. That goes even to fundamentals; and purely from the standpoint of the good of my own stockholders, I think I gave more effect to the acquisition of trusts than should have been given for the profits obtained.

He said that maybe he could have made more money otherwise. He did make a substantial amount of money, and I think the record should indicate that all the money made did not go to Mr. Odlum, but was allocated among his Atlas stockholders.

Mr. Odlum went on to say:

Personally I would welcome some public body or arbiter who could pass on the equities as between divergent interests in such matters as mergers, reorganizations, and exchanges of securities, not to substitute their judgment for that of the management, but to see that things are at least within the range of upper and lower limits within which reasonable men can properly differ.

That is the problem, and it is not an academic problem; because when did these exchanges take place? There is no fun changing dollar for dollar; you cannot make any money that way. The only time an exchange pays is when you can buy somebody's dollar for less than a dollar. All these exchanges took place when investment company securities were selling at a discount and when they could entice or induce the person to make the exchange—say, where there was a dollar asset value for the security, but it was selling for only 80 cents on the market. They could give him 90 cents, which would be 10 cents more than the market but 10 cents less than the asset value.

We have that same situation today. Investment company securities are selling at a discount; and I personally feel that if you do not pass this legislation, you are going to get these elaborate exchanges, with small companies trying to build up their fund in that way, particularly in view of the fact that they cannot at the present time raise new capital through the sale of securities.

So we think this is an important problem which merits the consideration of the committee, and that the Commission ought to be given the right to approve or disapprove the exchange of securities, within those limits and circumstances.

There is just one other thing: I should like to introduce a memorandum on section 25, which discusses the problem——

Senator Hughes. Could you state—and your recollection is better than mine—just as briefly as possible what opposition was made to that?

Mr. Schenker. Oh, the opposition that was made.

I think the objection was that the provision was undemocratic—that the majority could not have its way.

Curiously enough, the person who asserted that noble sentiment—is a person whose company was the one that refused to abide by the judgment of the majority. It was his company that went in and got an injunction in connection with a particular merger, you see.

Of course, as I said in the case of a judicial reorganization, the Supreme Court of the United States did not have any difficulty with this "undemocratic procedure" of protecting the minority stockholder, even though the majority wanted that particular exchange to take place.

Now, this statement discusses the law and shows the impotence of the minority stockholder at the present time.

We are submitting this memorandum in connection with section 25.

Senator HERRING. Do you want that memorandum in the record, or just filed?

Mr. SCHENKER. Yes; I think it ought to be reprinted.

Senator HERRING. Yes.

Senator HUGHES (presiding). Yes.

(The memorandum "Statement of the Securities and Exchange Commission with reference to section 25 of the proposed investment company bill" is as follows:)

STATEMENT OF SECURITIES AND EXCHANGE COMMISSION WITH REFERENCE TO SECTION 25 OF THE PROPOSED INVESTMENT COMPANY BILL

A. OBJECTIVES OF THE SECTION

Section 25 of the proposed investment company bill is intended to erect a safeguard to protect investors in investment companies from unfair treatment in the case of voluntary and involuntary reorganizations of their companies, and the rights, preferences, incidents and values of their securities.

Reorganization plans of insolvent investment companies drastically affect the rights of creditors, bondholders, and stockholders. Although priorities of claims must be respected, the necessities of the situation may require bondholders to become stockholders. Preferred-stock holders may be required to become common-stock holders. Assets values, dividend rights, and other incidents of securities may be changed by such plans. However, as will be pointed out, security holders are afforded a substantive measure of protection where the reorganization is supervised by Federal courts under the Chandler Act.

Similarly the rights and values of security holders may be severely altered in voluntary reorganizations, effected by exchange offers of securities, "switches" of securities from one company to another, mergers, consolidations, sales of all the assets of investment companies to other investment companies, recapitalization and dissolution plans.

Recapitalization plans have for their purpose the readjustment of the rights, privileges, and values of existing securities of a single investment company. For example, where preferred stocks have large dividend arrearages, it is possible by such plans to eliminate such dividend arrearages by reclassifying the securities of the company and exchanging new securities for the old preferred stocks. These plans may be highly advantageous to the common stockholders. Such plans may enable the common stockholders to obtain dividends on their stocks which in the absence of a recapitalization could not be paid because of the dividend arrearages on the preferred stocks. Write-downs of capital accounts may also be effected which will create surplus available for payment of dividends to the common stocks, thus pro tanto destroying the "cushion" of assets for preferred stocks. These are only two examples of the changes in the rights of stockholders which can be effected by voluntary recapitalization plans.

Dissolutions of investment companies may also result in unfair treatment to stockholders where a large proportion of the assets of such companies consist of securities for which no quoted market values are obtainable. Since the management under State laws is almost invariably vested with the function of determining the aliquot portion of the assets distributable to stockholders, the values they give to portfolio assets may favor one or more classes of securities. For example, assume that the investment company has outstanding $5,000,000 of preferred stock and a common stock. The assets consist of securities which have no ascertainable market value. If their assets are really worth only $5,000,000 or less, the entire assets must be distributed to the preferred-stock holders. However, a management with substantial holdings of common stock may evaluate the assets at an extravagant figure in order to justify distribution of a portion of the assets to common-stock holders. About the only remedy the preferred-stock holders would have in such case is a lawsuit to restrain the unfair distribution of assets. However, as will be pointed out later, legal proceedings are beyond the means of the average stockholder in an investment company.

The ultimate result of mergers, consolidations, and sales of the assets of one investment company to another is the concentration of the assets of one or more formerly independent companies in one of the old companies or in a new company. Securities of the successor company are issued for the securities of the old companies. In the achievement of this result, a nonjudicial reorganization of the

rights, privileges and financial position of the stockholders of the various companies is accomplished. As will be developed later, stockholders are singularly helpless to protect themselves against unfair voluntary plans of reorganization and recapitalization even though the facts which render such plans unfair may be fully disclosed to the stockholders.

These voluntary reorganizations of investment companies have been of frequent occurrence in the past. On the basis of balance sheet valuations of the acquiring companies all exchanges of securities in connection with or immediately preceding merger and consolidation or sales of the entire assets of investment companies to other companies, involved the issuance of $873,000,000 of securities during the years 1927 to 1935. Almost 50 exchange offers of its own securities were made between 1933 and 1935 by The Equity Corporation for the securities of 11 investment companies which it absorbed during that period. Atlas Corporation made 43 exchange offers of its securities for the securities of the 21 investment companies which it acquired. Associated Gas & Electric Co. made approximately 60 exchange offers for the securities of Eastern Utilities Investing Corporation which it controlled and the assets of which it had used to further its own purposes.

A significant stimulus for the effectuation of voluntary reorganization is the fact that the securities of closed-end management investment companies are selling in the market at prices approximately 30 percent less than their aggregate asset values—a condition which has existed since 1929. In this situation a profit equivalent to this 30-percent difference between the market value and the asset values of closed-end investment company shares can be made by acquiring through exchange offers, merger, or consolidations, the outstanding shares of such companies for a consideration in securities equivalent to or less than the market value of the exchanged securities. This in essence was the purpose of both the Atlas Corporation and the Equity Corporation in their extensive campaigns between 1930 and 1935 to acquire investment companies. These two companies alone absorbed over 30 other investment companies from 1930 to 1935.

The extensive voluntary reorganizations of investment companies which have occurred in the past have substantially affected the rights and values of stockholders. For example, the stockholders of 21 investment companies who accepted the exchange offers of Atlas Corporation between 1930 and 1933 suffered aggregate losses in asset values at the time of the exchanges of approximately $13,000,000. (See pt. 3, ch. IV of the Commission's Report on Investment Trusts and Investment Companies.)

Almost invariably the preferred stockholders of the companies acquired by Atlas Corporation became common-stock holders of Atlas Corporation as the result of their acceptance of exchange offers. Similarly, stockholders of the investment companies who accepted the exchange offers and agreements of merger and consolidation of The Equity Corporation suffered losses in asset value in excess of $2,000,000. Preferred-stock holders of the various companies absorbed by the Equity Corporation received securities having liquidating preferences $8,400,000 less than the liquidating preferences of the securities they had previously held. Preferred-stock holders of the various Founders companies which were consolidated to form the present American General Corporation were required to relinquish approximately $4,000,000 in dividend arrearages on their existing preferred stock. In addition, they were required to accept preferred stocks of the consolidated company with a substantially smaller dividend rate than that possessed by the preferred stock which they had previously held.

The recently proposed merger of Atlas Corporation and Curtiss-Wright Corporation is also illustrative of the effect in another direction that voluntary reorganization plans may have on stockholders of investment companies. Under this proposed plan preferred-stock holders of Atlas Corporation, an investment company, will be asked to become preferred-stock holders of a company engaged in the manufacture of airplanes, a radical change from their previous position as stockholders of investment companies.

These examples illustrate the extent and seriousness of the change in the rights, preferences, and values of securities of investment companies held by a large number of small investors which are accomplished by plans of voluntary reorganization.

It is important to note that if these voluntary reorganizations are approved by the required majorities of shareholders, minority stockholders—unless they exercise certain remedies which will be described later and which are generally beyond the reach of the average stockholder—will be bound by the will of the majority.

As now drafted section 25 prohibits the solicitation of proxies, consent and authorizations to voluntary and involuntary reorganization plans, the sub-

mission of such plans to United States courts and the approval of such plans by such courts until a declaration with reference to such plans has been submitted to the Securities and Exchange Commission and has by order of that body become effective. The Commission can refuse to permit a declaration to become effective only if the plan is not fair and equitable to all classes of securities affected thereby, is not feasible in the case of a plan of reorganization, or is inconsistent with the purposes of the bill.

The section also makes provision for the exemption of reorganization plans from the other provisions of the bill if the Commission find that such exemption is consistent with the public interest and the interests of investors, and is necessary or appropriate to the effectuation of the plan of reorganization or offer of exchange. For example, the plan to be fair to all classes of securities holders may require the issuance of preferred stock or even bonds by an investment company. In such cases section 25 permits the Commission to exempt the plan from the provisions of section 18 which prohibit the issuance in the future of senior securities by investment companies.

The provisions of section 25 with reference to judicial reorganization were modeled upon similar provisions in the Public Utility Holding Company Act of 1935 and in section 77 of the Bankruptcy Act which requires the Interstate Commerce Commission to approve railroad reorganization plans prior to their submission to the courts.

However, at the suggestion of Senator Herring it is understood that the section is to be revised in the case of judicial reorganizations of investment companies in the Federal courts to provide that the Commission shall merely render an advisory report on the fairness and feasibility of plans of reorganizations. These advisory reports which are in some cases already rendered by the Commission to the courts pursuant to chapter X of the Chandler Act will not be binding upon the courts. However, the Chandler Act makes it mandatory to submit plans of reorganization to the Commission for advisory reports only where the indebtedness of the insolvent company exceeds $3,000,000 although the courts may submit plans to the Commission for advisory reports in any case. It is proposed in this bill that the courts will be required to submit to the Commission for advisory reports suggested plans of reorganization for investment companies irrespective of the amount of outstanding indebtedness of such companies.

In the case, however, of voluntary reorganizations which are consummated outside of and beyond the supervision of the courts, the Commission urges that the present provisions of section 25 be allowed to stand. The safeguards erected for investors in judicial reorganizations do not exist in the case of voluntary nonjudicial reorganizations. The differences in the protection afforded to investors in the two types of reorganizations will be described later.

(1) *The approval of voluntary reorganizations by Government bodies is not without precedent.*—Mr. Quinn, of Tri-Continental Corporation, in his testimony suggested that the provisions of section 25 of S. 3580 insofar as they apply to voluntary reorganizations by investment companies by exchange offers of securities, mergers, consolidations, sales of the entire assets of such companies to other companies, and recapitalization plans were unprecedented. In fact, similar provisions already exist in three States so that this section marks no new departure in administrative law.

The California Securities Act (laws of 1917, ch. 532), enacted as long ago as 1917, contains in section 4 the following provision:

"Pursuant to this Act the Commission has been and is authorized in the instance of an application for a permit to issue securities in exchange for one or more bona fide outstanding securities, claims or property interests, or partly for cash, to approve the terms and conditions of such issuance and exchange and the fairness of such terms and conditions, after a hearing upon the fairness of such terms and conditions, at which all persons to whom it is proposed to issue securities in such exchanges shall have a right to appear."

The South Carolina Securities Act laws 1937, Act No. I, section 11 provides:

"The commissioner is authorized and empowered on application to consider and to conduct or hold hearings upon any plan of reorganization or recapitalization of a corporation organized under the laws of this State, or domiciled or having its principal place of business within this State, proposed by such corporation or by its stockholders or creditors by which proposed plan of reorganization or recapitalization it is proposed to issue securities in exchange for one or more bona fide outstanding securities, claims, or property interests, or partly in such exchange and partly for cash, to approve the terms and conditions of such issuance and exchange and the fairness of such terms and conditions after a hearing upon the

fairness of such terms and conditions, at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear; also to approve fair and reasonable terms and conditions for any resale of such securities issued in such exchange to the end of preventing fraud or deception in any such exchange or the resale of any securities so issued in such exchange."

The West Virginia Securities Act (W. Va. Code (1931), ch. 32, art. I sec., 11), although not an approval statute permits the securities commissioner to make changes in any plan of recapitalization and reorganization which he deems necessary for the protection of investors. The act provides:

"Securities issued or to be issued to the security holders or creditors of any person in the process of a bona fide reorganization, recapitalization, merger, rearrangement of capitalization, or any other plan or proposal for the readjustment of the business of such person * * * shall be registered as provided * * * by this article.

"Registration must be made prior to the time of the solicitation and prior to the offer or proposal of any plan * * * to the security holders or creditors of such person.

"* * * The commissioner may also require information about or related to any plan * * * and the commissioner may rsquire any change to be made in such plan * * * he deems necessary for the protection of the interest of investors."

Mr. Quinn of Tri-Continental Corporation in his testimony before this committee asserted that the determination of what was a "fair and equitable" plan was a matter in the sole discretion of the Commission.

Mr. Quinn, however, ignores the fact that the elements of a "fair and equitable" plan of reorganization have been defined with considerable precision by the courts in the field of judicial reorganizations (*Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106 (1939)), and in the field of voluntary nonjudicial reorganizations by mergers, consolidation, sales of all corporate assets, and recapitalizations. See part III, chapter IV, of the Commission's Report on Investment Trusts and Investment Companies; and part VII of the Commission's Report on the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees.

Section 25 of the investment company bill does not give the Commission arbitrary powers. Its orders promulgated pursuant to that section are reviewable by the courts. The principles enunciated by the courts for determining the fairness of plans thus constitute precedents which the Commission must follow if applicable to the facts and circumstances of the plans scrutinized by it.

B. THE PROTECTION PROVIDED FOR INVESTORS IN JUDICIAL REORGANIZATIONS

Under the Chandler Act investors and creditors of insolvent companies in reorganization obtain the protection of (1) full disclosure including in certain cases an advisory report by the Securities and Exchange Commission on the fairness and feasibility of proposed plans and (2) independent scrutiny of the fairness of the plan by the court. In general, the Chandler Act requires the following procedure: Plans are submitted to the court and those plans which the court deems worthy of consideration are, if the indebtedness of the company exceeds $3,000,000, transmitted by the court to the Securities and Exchange Commission for our "advisory" report as to their fairness and feasibility.

After the submission of the advisory report, the court must independently approve the plans. Thereafter the plan is submitted to the creditors and stockholders affected for their approval or disapproval. No solicitation of proxies or consents is permitted until the court has approved the plan and ordered its transmittal to the creditors and security holders affected, accompanied by the Commission's advisory report and such other documents as the court may determine. The investors affected are thus given the advantage of full disclosure and impartial analysis of the fairness of the plan. Following the approval of the plan by the required vote of the creditors and stockholders, a hearing is held to confirm the plan. At the hearing objecting security holders and creditors may oppose the plan. The plan becomes effective only after it has been finally confirmed by the court after such hearing.

Mr. Quinn of Tri-Continental Corporation in his testimony before the committee professed to find something novel in section 25 in that such section permitted the Commission to override the "democratic" rule that the will of the majority without interference shall govern the minority. Nevertheless the courts in reorganization proceedings are required to scrutinize a plan of reorganization for its fairness even though it has been approved by the required majority of creditors and security holders entitled to vote on the plan. If the plan, although approved by the majority, is unfair in the opinion of the court, it must refuse

to confirm the plan. In its most recent pronouncement on the subject, the Supreme Court has stated: [1]

"* * * Where a plan is not fair and equitable as a matter of law it cannot be approved by the court even though the percentage of the various classes of security holders required * * * for confirmation of the plan has consented * * * Accordingly the fact that the vast majority of the security holders have approved the plan is not the test of whether the plan is a fair and equitable one. * * * The contrary conclusion in such cases would make the judicial determination on the issue of fairness a mere formality and would effectively destroy the function and the duty imposed by the Congress on the District Court under sec. 77B. That function and duty are not less here than they are in equity receivership reorganizations where this court said 'Every important determination by the court in receivership proceedings calls for an informed independent judgment.'"

To sum up, in judicial reorganizations investors obtain the protection both of full disclosure and independent scrutiny of the fairness of the plan.

C. PROTECTION FOR INVESTORS COMPARABLE TO THAT IN JUDICIAL REORGANIZATIONS DOES NOT EXIST IN VOLUNTARY REORGANIZATIONS

In the case of voluntary reorganizations investors in investment companies usually have at present neither the protection of full disclosure nor of independent scrutiny of such plans. With the exception of the three States which have approval statutes, the fairness of plans of voluntary reorganization and recapitalization are subjected to no governmental scrutiny. Nor is any disclosure of the nature, terms and effects of such plans on existing securities generally required. The Securities Act of 1933, although applicable to exchange offers of the securities of one company for those of another effected by the use of the mails and the facilities of interstate commerce, is not applicable to mergers, consolidations, and sales of corporate assets effected pursuant to the provisions of State laws. Recapitalization plans by which new securities of an investment company are exchanged for its existing securities are subject to the provisions of the Securities Act only if remuneration is paid for the solicitation of such exchanges. The Securities Exchange Act of 1934 requires full disclosure in connection with plans of voluntary reorganization only in the case of securities listed on national securities exchanges. However, over 75 percent of existing investment companies with assets aggregating $1,769,000,000 at the end of 1936 had no securities listed or admitted to unlisted trading privileges on national securities exchanges. Thus, investors in investment companies owning a substantial amount of the total assets of the investment company industry are without the protection of the disclosure provisions of either the Securities Act of 1933 or the Securities Exchange Act of 1934 in connection with the merger, consolidation, recapitalization of their companies, or sales of their assets.

The State incorporation and blue-sky laws almost uniformly do not include within their provisions a requirement of full disclosure of the terms and conditions of mergers, consolidations, sales of assets, and recapitalization plans.

Thus, at present, managements are comparatively free to propose to the stockholders and to consummate unfair plans of voluntary reorganization, unless restrained by the courts—a remedy which for most stockholders is largely theoretical. The unfairness of the plans need not be disclosed and scrutiny of the plan by an independent body is nonexistent. In the past many investment company managements have utilized such plans to further their own interests to the detriment of the stockholders. Numerous examples may be found in part 3, chapter IV, of the Commission's report. Two examples may be given here. In September of 1931 National Securities Investment Co., a company sponsored and controlled by A. G. Becker & Co., Inc., of Chicago, had net assets of $11,000,000. It had outstanding preferred stock entitled to a liquidating preference of over $13,000,000. The common stock thus had no asset value. Two-thirds of the common stock had been acquired by A. G. Becker & Co., Inc., at cost of $1,900,000. This stock (which represented control of the investment company) A. G. Becker & Co., Inc., offered to sell to Atlas Corporation for $1,900,000.

However, Atlas Corporation refused to invest $1,900,000 in this worthless stock unless A. G. Becker & Co., Inc., agreed to aid Atlas Corporation to purchase or acquire in exchange for its own securities, the preferred stock of National Securities Investment Co. for a total consideration less than the asset values of such preferred stock. This the banking house agreed to do, it being understood that Atlas Corporation would pay the $1,900,000 for the banking firm's common stock

[1] *Case* v. *Los Angeles Lumber Products Co.* (308 U. S. 106 (1939)).

out of its ultimate profits on its acquisition of the preferred stock of the investment company. The preferred stock of National Securities Investment Co. which had a par value of $100 a share had an asset value of about $72 a share and was selling in the open market in September of 1931 at about $50 a share—a substantial discount from its asset value. A. G. Becker & Co., Inc., was supporting the market in the preferred stock by buying and selling it in the market. These market-supporting activities were undertaken to provide the preferred-stock holders with a market for the shares which would not otherwise exist. However, as part of its agreement with Atlas Corporation, A. G. Becker & Co., Inc., agreed to cease supporting the market in the preferred stock of National Securities Investment Co. and to purchase such stock only for the account of Atlas Corporation and at prices dictated by Atlas Corporation.

With the aid of A. G. Becker & Co., Inc., Atlas Corporation succeeded in acquiring 95 percent of the preferred stock of National Securities Investment Co. at a price approximately $3,000,000 less than the liquidating value of such stock. Out of this gain in asset value at the expense of the preferred stock holders of National Securities Investment Co., Atlas Corporation paid A. G. Becker & Co., Inc., $1,900,000 for its worthless common stock. In addition, A. G. Becker & Co., Inc., received $50,000 for its services in inducing the preferred-stock holders of National Securities Investment Co. to accept Atlas Corporation's stock in exchange for their own stock even though the exchange meant a severe loss in asset values of the preferred-stock holders. The fact that Atlas Corporation was paying A. G. Becker & Co., Inc., commissions for its services was not disclosed to the preferred stock holders.

The net effect of the transaction was that the preferred-stock holders ultimately were compelled to bear the cost of the purchase of A. G. Becker & Co., Inc.'s, common stock by Atlas Corporation. The preferred-stock holders suffered large losses in asset value. A. G. Becker & Co., Inc., disposed of its entire investment in National Securities Investment Co. without any loss. Furthermore it obtained $3 a share for its common-stock holdings in National Securities Investment Co. whereas the public holders of the common stock obtained from Atlas Corporation sums ranging from 50 cents to $1.50 for their common stock.

Another example is the consolidation in 1937 of National Investors Corporation, Second National Investors Corporation, Third National Investors Corporation, and Fourth National Investors Corporation. National Investors Corporation had outstanding in 1937 (in addition to preferred stock) common stock and option warrants neither of which had any asset value. Large blocks of this common stock and warrants were held by interests affiliated with the common management of the four companies. The principal assets of National Investors Corporation consisted of common stocks and warrants of the other companies which had no asset value. The consolidation plan, however, in essence provided that over $2,000,000 of the asset values of the public stockholders of Second, Third, and Fourth National Investors Corporations were to be transferred to the common stock and warrants of the National Investors Corporation, large blocks of which as has been said, were held by interests affiliated with the management which was the proponent of the plan. This $2,000,000 loss in asset values suffered by the public-stock holders of the three other companies was not theoretical. The new company created by the plan was an open-end company so that the $2,000,000 in asset value created for the previously worthless common stock and warrants of National Investors Corporation out of the assets belonging to the public-stock holders of the other companies could be immediately realized by the common-stock holders and warrant holders of National Investors Corporation.

D. FULL DISCLOSURE IS INSUFFICIENT PROTECTION FOR INVESTORS AFFECTED BY VOLUNTARY REORGANIZATIONS

Section 20 of the proposed investment company bill empowers the Commission to require full disclosure with reference to plans of voluntary reorganization. Mr. Quinn of Tri-Continental Corporation in his testimony before this committee contended that this was a sufficient protection for the investor.

The Commission's experience, however, has been that investors are helpless to combat unfair plans of voluntary reorganizations even if the unfairness of the plan is fully disclosed to them. This is not because as Mr. Quinn charges that the Securities and Exchange Commission believes investors are incompetent or unable to decide for themselves that a plan is unfair. As will be described shortly, even if a plan is unfair to the knowledge of investors they are generally powerless to defeat it.

First, a large number of investors are not security analysts. Plans of reorganizations are complicated. The literature describing such plans uses many technical, legal, and financial terms. In many cases these plans even if fully disclosed will be confusing and incomprehensible to investors. Mr. Quinn admits this himself in his testimony. In discussing the proxy regulations under the Securities Exchange Act of 1934 which requires full disclosure of plans of voluntary reorganization affecting securities listed on National Securities Exchanges, Mr. Quinn stated:

"I would like, however, to say that the present proxy regulations to my mind work out to the utter confusion of a portion of the stockholders because it requires so much information that he really doesn't get a clear picture of it."

Of paramount importance in any determination of the effectiveness of stockholders action against fully disclosed plans of voluntary reorganizations which are unfair is the extent of the investment of the great majority of stockholders in investment companies. The widespread geographical distribution of the stockholders of investment companies must also be considered to obtain a realistic picture of the impotence of stockholders.

Figures for 18 investment companies show that approximately 65 percent of the common stockholders of these companies hold 50 shares or less; 95 percent of the stockholders hold 500 shares or less. Similarly, over 83 percent of the preferred stockholders of the investment companies hold 50 shares or less and over 93 percent hold 100 shares or less.

In terms of market values, over 60 percent of all common stockholders of these investment companies hold common shares with a market value of $500 or less and the holdings of over 75 percent of common stockholders of investment companies have a market value of $1,000 or less. Of the preferred stockholders 37 percent hold shares with a market value of $500 or less; about 54 percent hold shares with a market value of $1,000 or less and 93 percent hold shares worth a market value of $5,000 or less. (See part II, chap. V, of the Commission's report on investment companies, pp. 386 and 434.)

These stockholders are situated in every State and never attend corporate meetings. The Commission's record indicates that not more than one or two stockholders attend most meetings. Almost one-half of the incorporated investment companies are incorporated in Delaware and stockholders' meetings are almost invariably held in cities in that State. For stockholders residing in California, Ohio, New York, Illinois, or Massachusetts, States in which the bulk of stockholders of investment companies reside, the traveling expenses which would be incurred in attending meetings in Delaware prohibit their attendance at such meetings.

Now let us assume that the stockholders receive notice of a plan of voluntary reorganization which fully discloses its unfairness. What are the remedies of shareholders?

(1) *The effectiveness of voting rights.*—(*a*) The stockholder may vote against the plan. However, to do so he must appear at the meeting or retain someone to appear for him. Normally the management solicits and acts as proxy for the stockholders only to vote acceptance of the plan. The expense of attending the meeting to vote or to retain a proxy to vote for him may exceed the loss the stockholder will suffer under the plan.

(*b*) In a large number of cases the management holds a sufficient number of votes to enable it to consummate the plan by its own votes. (See pt. 3, ch. IV, of the Commission's Report on Investment Companies.)

(*c*) Preferred stockholders without voting power may have no vote with reference to plans of reorganization which adversely affect their interest. In at least five States the statutes provide for approval of a corporate merger or consolidation only by holders of voting stock. The only remedy of nonvoting stockholders is their right to obtain in cash the appraisal value of their shares, a remedy which, as will be described later, is in reality an ineffective one. For example, in Delaware, a State in which more than a majority of incorporated investment companies have been organized, the entire assets of an investment company can be sold for the securities of another investment or other company by the vote of a majority of the voting shares. Preferred stockholders without voting rights cannot vote on the sale. Furthermore, if the sale in their opinion affects them adversely, they do not have the right which exists in some cases as will be discussed later to demand in cash the appraisal value of their stock.

(*d*) Security holders in investment companies which in form of organization are business trusts have no voting power. At the end of 1936, out of 152 management investment companies with assets in excess of $500,000 each, 20 were business trusts owning assets valued at market at the end of 1936 at $218,000,000, the

equivalent of 12.2 percent of the total assets of all 152 companies. In only 2 cases out of the 20 cases were the security holders given any voice in a possible sale of the entire assets of the trust for the securities of other investment companies. In all of the other cases the trustees alone had the power without the approval of stockholders to transfer the entire trust assets to another trust or corporation for either cash or the securities of the purchasing trust or corporation. Nor do the security holders in these trusts have the right sometimes accorded to stockholders of corporations in the same situation, to secure the appraised value of their shares in cash if they are opposed to the sale.

(*e*) The stockholder can refrain from voting in the hope that his fellow stockholders will also refrain from voting in sufficient numbers to prevent the consummation of the plan. However, if the management already has sufficient votes to consummate the plan this will not help the stockholder. Moreover, if the management has not sufficient votes to effect the plan it will have available the funds of the corporation to conduct extensive campaigns of personal solicitation of stockholders by brokers, dealers, bankers and others who will be paid for their services. For example, the Atlas Corporation in June, July, and August of 1932 paid approximately $400,000 in commissions to virtually every known banker, broker, and security dealer in the country for their aid in inducing stockholders of its subsidiary investment companies to accept exchanges of Atlas Corporation's securities for the securities of such subsidiaries. Similar tactics were used by the Equity Corporation. See part 3, chapter IV of the Commission's report on investment companies. The Commission's record indicates that in their personal solicitation of stockholders, dealers spurred by the incentive of commissions, will use unfair tactics to induce acceptance of plans and exchange offers of securities. To indicate the type of pressure employed a letter written to the Commission by a stockholder on January 24, 1937, may be cited:

"In the fall of 1933 a representative of the Equity Corporation called at my home and tried to induce me to exchange my stock for Equity stock offering me 2 shares of Equity for 5 shares of American Founders pointing out at the time that American Founders was quoted at one-half and Equity at 1½ so the trade would be profitable to me. I realized that the portfolio of American Founders represented a greater value per share than the market showed so I argued against trading. The agent then stated that if I would not trade it would be just too bad for me as the Equity Corporation was planning on getting control of American Founders and then dissolving it so I would lose everything."

(2) *Effectiveness of appraisal rights.*—In some States stockholders dissenting from plans of merger, consolidations or sales of the assets of one company for the securities of another may be entitled to receive in cash an appraisal value of their shares. In some States the basis of valuation for this purpose is market value, a valuation which may be unfavorable to investment company stockholders, since, as has been stated, the securities of most closed-end management investment companies are selling in the market at prices between 30 and 40 percent less than their asset value. In most States, however, the stockholder is entitled to receive the "fair" value of the stock.

The appraisal right enables dissenting stockholders to escape from the operation of an unfair [or a fair] merger or recapitalization plan but does not enable them to prevent or undo its consummation. Minority stockholders who do not desire to cash in their shares at their appraisal value still have no other protection against an unfair plan than the doubtful expedient of legal action to enjoin or set aside such plan.

However, in 5 States authorizing mergers and consolidations of investment companies, no appraisal rights are granted dissenting stockholders. In 15 States which authorize corporations to sell their entire assets to other corporations, stockholders dissenting from such sales have no appraisal rights. In 8 States which authorize mergers, consolidations, and sales of entire corporate assets, appraisal rights are granted in the case of merger and consolidations but not in the case of sales of assets. Only 11 States permit stockholders to demand an appraised value of their shares if they are dissatisfied with recapitalization plans. These States, however, do not include Delaware, the leading State for incorporating investment companies, and Maryland, the second leading State for incorporation of investment companies.

As a result of this diversity of State laws stockholders of investment companies incorporated in particular States may have no appraisal rights. In practice sponsors of investment companies incorporate them in States which grant the least power to stockholders. Thus, over one-half of all incorporated investment companies are incorporated in Delaware. In this State stockholders dissatisfied with recapitalization plans have no appraisal rights. Appraisal rights are granted

in cases of mergers and consolidations but not in the case of the sale of the assets of one investment company to another such company either for cash or the purchasing company's securities—a procedure which accomplishes exactly the same purpose as a merger or consolidation. Moreover, in the case of a merger or consolidation in Delaware, the vote of the holders of two-thirds of the company's stock, including normally nonvoting stock is required. In the case of a sale of assets, however, only a vote of the majority of the shares endowed with voting power in the company's charter is required. In practice investment companies incorporated in Delaware which desire to combine will be likely to select the sale of assets method to achieve their purpose in order to avoid the possibility of the exercise of appraisal rights by stockholders. For example, the combination of the National Investors Corporation and its affiliated companies, which, as has been described, was detrimental to the interests of stockholders of the affiliated companies was accomplished by the sale of assets method in furtherance of a deliberate desire of the management to prevent stockholders of the affiliated companies from obtaining an appraisal value of their shares.

Realistically, therefore, stockholders of the investment companies incorporated in Delaware will have no appraisal rights if they are dissatisfied with a proposed combination of their companies with other companies by way of a sale of assets—the method almost invariably chosen by managements. Similarly, they will have no appraisal rights if they are opposed to plans to recapitalize their companies.

Even if the stockholder has an appraisal right the remedy is valueless to the small stockholder, and as has been pointed out, the number of shares and the financial stake of the great majority of investors in investment companies is comparatively small. For example, in Delaware in order to obtain an appraisal the stockholder must file a written dissent from the plan of reorganization and thereafter make a written demand upon the company for payment of what the stockholder considers the fair value of his shares. If the corporation refuses to pay the price demanded by the stockholders, he must apply to a Delaware court for the appointment of appraisers. This means, for example, that a stockholder who is a resident of Ohio must seek out a Delaware attorney and pay him a fee for instituting and maintaining the proceedings. It is readily apparent that the great majority of stockholders of investment companies who hold securities worth from $100 to $1,000 may not be able to afford the expense of these proceedings. Thus, if, as is true in the case of the great majority of stockholders in investment companies, the appraisal costs, court costs, and attorneys' fees bear a disproportionate ratio to the value of the shares held by the dissenting stockholders, the statutory remedy of appraisal is valueless, except, of course, where costs are assessed against the corporation. Except in such cases the dissatisfied minority stockholders will probably lose less by selling his shares in the market or by accepting the valuation placed thereon by the corporation than by litigating the valuation issue involved. Only a dissenting stockholder owning a comparatively large number of shares can afford to insist upon his strict appraisal rights.

(3) *Legal proceedings.*—In his testimony with reference to section 25 of the bill Mr. Quinn of Tri-Continental Corporation stated:

"Mr. Schenker in his comment made the further illuminating statement. He said: 'Sometimes the majority wish to do something which might be bad for the minority.' At least, so I understood his statement.

"What kind of a new doctrine is this, that a governmental agency is going to decide all questions for shareholders? Is the democratic rule of the majority no longer to hold, but must we all come down to find out what we can do and what cannot be done, regardless of existing laws, regardless of existing rights, and regardless of the wishes of those people who are concerned."

Mr. Quinn has overlooked the fact that the courts which certainly are governmental agencies have frequently interfered with the "democratic rule of the majority" where the rule of the majority is oppressive upon the minority or is an attempt to defraud or unfairly treat the minority. Minority stockholders may be granted injunctions or other equitable relief against unfair mergers, consolidations or sales of the corporate assets on the theory that the statutory power to merge or consolidate under existing laws, like other corporate powers, is subject to equitable limitations and cannot be exercised fraudulently or oppressively by the management or other controlling interest of a corporation.

Nor does Tri-Continental Corporation really believe that the democratic rule of the majority (free from any interference) should govern in all cases of merger and consolidation. In 1937 the common management of Alleghany Corporation and Chesapeake Corporation proposed a plan to consolidate the two corporations, Tri-Continental Corporation and Selected Industries, Inc., an affiliated investment company together held 36,500 shares of the common stock of Chesapeake

Corporation. However, Alleghany Corporation held 71 percent of the common stock of Chesapeake Corporation. In several aspects the plan proposed by the common management of Alleghany Corporation and Chesapeake Corporation was detrimental to the common stock of Chesapeake Corporation. As has been stated the plan was satisfactory to the holder of 71 percent of the common stock of Chesapeake Corporation. Tri-Continental Corporation was unwilling to let the democratic rule of the majority govern. It did not ask for the cash appraisal value of its Chesapeake Corporation stock. Instead it sought with others an injunction to restrain the consummation of the plan by the majority stockholders and an injunction was granted by the courts because of the unfairness of the plan to a certain class of Alleghany Corporation stock. Clearly the officers and directors of Tri-Continental Corporation were of the opinion that the majority should not rule where their acts are unfairly and inequitably oppressive of the minority. This doctrine is the guiding principle of section 25 of the investment-company bill.

Minority stockholders thus may have the remedy of judicial relief against unfair plans of voluntary reorganization. This however, is not true in two States, Michigan and California, which by statute expressly restrict the remedies of minority stockholders to their appraisal rights.

Nor is the remedy of judicial relief an effective weapon for minority stockholders. Tri-Continental Corporation, with $33,000,000 of assets, can afford to and does retain the most capable firms of corporation attorneys in the country. It can afford to institute litigation to restrain unfair plans of voluntary reorganizations. But, as has been described, the investment of the great majority of stockholders in investment companies does not exceed $500. It would cost much more than the total investment of the average stockholder to retain an attorney to protect him by litigation from unfair plans of voluntary reorganization. The average investor in investment companies simply cannot afford to retain counsel of the experience and caliber available to the management or the majority stockholders proposing the plan. In addition to the expense of hiring an attorney the stockholder would have to bear the expenses of investigations, court costs, appeal costs, etc. Since the management is normally the proponent of a merger or consolidation plan, stockholders who are attacking such plan may find it difficult to obtain access to the books and records of the corporation. Without such access, it may be impossible either to furnish affirmative evidence of unfairness or to refute ingenious arguments advanced by the management in justification of the plan.

Thus the remedy of judicial relief is largely theoretical as far as the average stockholder in investment companies is concerned. And the ascertainment of the names of other stockholders who might share the expense of a suit or the formation of a protective committee is extremely difficult. The stockholder will be unable to contact other stockholders unless they possess an accurate and complete list of their names and addresses. But the list of stockholders is invariably possessed only by the management and may be obtainable only after judicial proceedings which are themselves costly. If stockholders are compelled to institute suit in order to obtain the list of stockholders from the management, which usually will be the case, by the time that such proceedings are terminated the management may have obtained the consent of a sufficient number of stockholders to its plan.

CONCLUSION

The purpose of section 25, in essence, is to place the protection to be given stockholders of investment companies faced with voluntary reorganizations on the same plane as that afforded them in judicial reorganizations. Section 25 gives the stockholder, in addition to the safeguard of full disclosure, the protection of independent scrutiny of the fairness of voluntary plans by an unbiased body. This protection is deemed necessary by the Commission not because of any underlying philosophy that investors are incompetent to handle their own affairs. The simple fact is that because of the smallness of the financial stake in investment companies owned by the great majority of stockholders in such companies and their widespread geographical distribution it is impossible for such stockholder to take advantage of existing remedies which they have even if they know they have them.

Mr. SCHENKER. There was a great deal of discussion by the open-end companies, to the effect, "Well, if the shareholders do not like our management, they can get out."

Superficially, that sounds like an effective argument. Of course, that is not my concept of an investment company.

It seems to me that if I pay you a 10-percent load for the privilege of having my money managed, the fact that I can get out at any time should not be authority for the managers to mismanage my money. Furthermore, my concept is that I am investing in a going concern and that my status as a stockholder should not depend on the good behavior or misbehavior of the people running the company.

It does not help me any to say, "If you don't like my bad management or mismanagement, you can take your money out," because the difficulty is that by the time the mismanagement has taken place, my interest may not be worth much.

Furthermore, as in the case of the Maryland Fund and others, we can show you letters by the score where investors wrote to us about this situation and we had to reply:

> We are sorry, but the company can do that because the trust indenture says so.

A security dealer writes us:

> Don't tell me the trust indenture says that; because the salesman said I can get my money back any time I want it, and I can't.

That is the situation.

We should like to introduce a memorandum, an analysis of the trust indentures of the open-end companies which shows the extent to which they can suspend the right of redemption. Also you have the problem of corporate law about repurchases only out of surplus, some of the complications created by these corporate laws, and what effect that would have on the right of redemption.

Senator HUGHES. Very well; it will be included.

(Memorandum entitled "Redemption provision of open-end companies" is as follows:)

MEMORANDUM RE REDEMPTION PROVISION OF OPEN-END COMPANIES

The public has invested more than one-half billion dollars in the securities of open-end management companies, and is investing large additional sums at the present time.[1] Undoubtedly, the most important single attribute which induces purchases of the securities of open-end companies by the public is the so-called "redemption feature" of such securities—that is, the assurance that the shareholder may tender his shares to the company and receive at once, or in a very short time, the approximate cash asset value of such shares as of the time of tender. Not only does this "redemption feature" form the principal selling argument of the open-end companies but it constitutes the chief basis of the preferential tax treatment first accorded the so-called "mutual" companies under the Revenue Act of 1936 and continued under the Revenue Act of 1938.[2]

The importance of the "redemption feature" of open-end management companies was repeatedly stressed before this subcommittee by representatives of that branch of the industry during the past week. It was several times contended, among other things, that the shareholders of open-end companies ought not to be accorded voting rights, as is proposed in various sections of Section 3580, because their ability to exercise the "redemption privilege" is in effect tantamount to a voting right.

Although not concurring in the least degree with this latter contention, the importance of the redemption feature of open-end securities appears to the Commission beyond question. Accordingly, it has seemed pertinent to us to inquire precisely how certain and dependable for the investor is the "redemption feature" of the various open-end securities.

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[1] See, for example, statement of Ferdinand Eberstadt of Chemical Fund before this subcommittee to the effect that Chemical Fund was started 2 years ago by himself and associates with an investment of $100,000, and now has assets exceeding $8,000,000.

[2] See Securities and Exchange Commission Report on Investment Trusts and Investment Companies, part II, p. 212, note 47, and part III, ch. III, pp. 3–5.

This inquiry was in fact forcibly suggested to us by receipt of a batch of letters last June and July from shareholders of The Maryland Fund, Inc., so-called open-end company, in which the public had invested more than $11,000,000 by the end of 1936, complaining that the company had wholly or partially suspended the redemption privilege for its shares. The study communicated with the company and received a reply from Ross Beason, its president, which read in part as follows: [3]

"Under the charter and under the prospectuses under which the stock of The Maryland Fund, Inc., was sold, the board of directors had the right, after the stock was listed as outlined in the prospectus, to withdraw the provision whereunder a shareholder might demand repurchase of his shares by the fund. Stock of The Maryland Fund, Inc., was listed on the Chicago Board of Trade on June 24, 1938. On June 7, 1939, the directors withdrew the right of resale to the fund, but instituted a regulation whereunder stockholders might deposit their shares with the fund, the liquidating value or repurchase price to be determined on the forty-eighth calendar day after deposit, and payment for the shares, less a discount of 3 percent, to be made within 3 full business days thereafter.

"On February 15, 1940, the board of directors rescinded the regulationa dopted on June 7, 1939, so that there is now no right of resale to the fund by shareholders."

The investment company's charter did in fact contain the clause adverted to by Mr. Beason. Unfortunately, it would seem that many investors do not study the complex provisions of investment-company charters before purchasing their stock. From the letters received by the Commission [4] it is clear that some, at least, of the shareholders had no idea that the charter of the company contained a provision permitting the company to nullify the redemption privilege merely by listing its securities on any stock exchange in a city with a population of 2,000,000. The effect of the withdrawal of the redemption privilege is indicated by the fact that the shares of the company are now selling at a discount of 25 percent from asset value,[5] which means that a stockholder desiring to sell his shares must suffer a loss of at least 25 percent because of the suspension of the redemption privilege, in addition to whatever loss he may suffer for other reasons. On the basis of total of assets, the aggregate loss in market value for all shareholders of this company has been over a million and a half dollars.[6]

Maryland Sponsors, the distributors of the shares of Maryland Fund, Inc., also sponsored another open-end company called Quarterly Income Shares, Inc., which at the end of 1936 had assets of $46,000,000. The charter of this company contained a clause respecting suspension of the redemption privilege identical with that of the Maryland Fund. This stock was also subsequently listed on the Chicago Board of Trade, and redemption of shares was then made subject to a waiting period of 48 days. The study has just learned that on February 15, 1940, the directors of Quarterly Income Shares further altered the redemption privilege to provide for redemption as of the 364 days after tender. This means a shareholder seeking to redeem from the company must wait an entire year before even learning how much he will receive for his share, and longer than that before he receives his money. Immediately before this change, the shares were selling at approximately asset value.[7] Immediately thereafter the price of the shares has dropped approximately 13 percent, in the face of an increase in the market average.[8]

A. TRUSTS

Of the 38 open-end companies studied, at the end of 1935 only 8 were in trust form, the remainder being corporations. Of the 8 trusts, 3 were organized in New York and 5 in Massachusetts. For the most part, the redemption provisions of the trusts are relatively dependable, although in several cases provision is made for suspending the redemption feature for any length of time that the New York Stock Exchange may be closed. The longest redemption period for the trusts as at December 31, 1935, were the 30-day provisions of Eaton & Howard Management Fund A, B, and F. Several indentures give the trusts the right to

[3] The full letter of Mr. Beason is appended at the conclusion of this memorandum. Without expressing any view as to its validity, attention is directed to Mr. Beason's opinion of the basic unsoundness of the open-end principle and his conclusion that "* * * we maintain that investment in a group of common stocks, coupled with a repurchase or deposit liability, is contradictory, and over a period of time will not prove workable in the best interests of stockholders."

[4] A copy of a letter received from a purchaser of the stock of the Maryland Fund, Inc., is appended at the conclusion of the memorandum. This letter is representative of others in the Commission file.

[5] Net asset value, February 29, 1940, $5.17; bid price, $3.90.

[6] Total net assets, February 1940, $5,899,745.

[7] Asset value, January 15, 1940, $8.15; bid price, $7.90.

[8] Bid price, February 29, 1940, 6⅞. Standard statistics 90-stock iudex on was 95.8 on January 15 and 96.3 on February 29.

determine liquidating values as of any day within a period of from 5 to 10 days, thus giving the managements the right to pick the lowest market within the allowed period.

Most important of the considerations affect the reliability of the redemption feature of certificates issued by business trusts is the possibility of abrogating such features through amendment of the declaration of trust or indenture. In the case of the three New York trusts, stockholders who dissent from any amendment to the trust indenture are entitled to have their stock redeemed. No such provision is found in the case of the five Massachusetts trusts. Instead, it is specifically provided that the indenture or declaration of trust may be amended if all (or merely a majority) of the directors so decide, provided a majority of the certificate holders assent (in only one case, the assent of two-thirds of the certificate holders is required). Although abrogation of the redemption feature would seriously impair the rights of the minority which did not assent thereto, these certificate holders would nevertheless presumably be without remedy, since they are expressly bound by all the provisions of the trust indenture, including the amendment provisions.[9] Relevant provisions as at December 31, 1935, of the eight trusts are summarized herewith. In some cases changes have been subsequently made in the provisions.

1. *Massachusetts Investors Trust* (Massachusetts trust, 1934).—Will repurchase at net asset value as of any date within 7 days after deposit, less 1 percent, but if New York Stock Exchange is closed, redemption right is suspended for the same period. Declaration of trust may be altered or amended at any time by written instrument signed by all the trustees and a majority of the outstanding shares.

2. *Century Shares Trust* (Massachusetts trust, 1928).—Trustees required to buy shares tendered to it for purchase, subject to following conditions: (1) That trust has available, or can secure, the funds necessary for the purchase, (2) that trustees may determine value as of any date within 10 days following tender, if New York Stock Exchange is open. Declaration of trust may be amended by unanimous action of trustees plus agreement of two-thirds of the certificate holders.

3. *Investment Trust Fund A* (New York trust, 1925).—Redeemable in cash or kind, at option of company, in 2 days. In case of amendments, dissenting certificate holders may redeem.

4. *Investment Trust Fund B* (New York trust, 1927).—Redeemable in cash or kind, at option of company, in 2 days. In case of amendments, dissenting certificate holders may redeem.

5. *Mutual Investment Fund* (New York trust, 1926).—Will redeem on the first business day of any month upon 10 days' previous notice. In case of amendment, dissenting certificate holders may redeem.

6. *Eaton & Howard Management Fund A1* (Massachusetts trust, 1932).—Must redeem in cash or kind within 30 days after notice of intention to redeem; valuation within 5 days of notice. Indenture may be amended if adopted by a majority of the trustees plus a majority in interest of the certificate holders.

7. *Eaton & Howard Management Fund B* (Massachusetts trust, 1932).—Must redeem in cash or kind within 30 days after notice of intention to redeem; valuation within 5 days of notice. Indenture may be amended if adopted by a majority of the trustees plus a majority in interest of the certificate holders.

8. *Eaton & Howard Management Fund F* (Massachusetts trust, 1932).—Must redeem in cash or kind within 30 days after notice of intention to redeem; valuation within 5 days of notice. Indenture may be amended if adopted by a majority of the trustees plus a majority in interest of the certificate holders.

B. CORPORATIONS

Of the 30 corporations studied, 7 were incorporated under the laws of Massachusetts, 7 under the laws of Maryland, 14 under the laws of Delaware, and 2 under the laws of the Dominion of Canada. Almost all the corporate charters which contain redemption provisions limit redemptions to surplus legally available therefor, or to assets or funds legally available therefor. Likewise, almost all the charters expressly or by implication provide for suspension of the redemption privilege for such period as the New York Stock Exchange may be closed, and in 1 case,[10] for such period as the Standard Stock and Mining Exchange of Canada

[9] Although an attempt to amend the redemption provisions of an indenture would doubtless cause a spurt in demands for liquidation, the extent of such increase would depend upon the speed with which the amendment was effected. In the case of trusts which impose a waiting period (e. g., 30 days for Eaton & Howard) the question would arise whether the shareholders' rights become vested as of the time of giving notice to redeem, or as of the end of the waiting period—at which time amendment may already be in effect.

[10] United Gold Equities of Canada, Ltd.

is closed. Four corporations reserved the right to withhold payments for a period of 60 days,[11] and others for a somewhat lesser period.

The charter of State Street Investment Corporation (the third largest open-end company in the country) is silent as to any redemption rights on the part of stockholders. The privilege rests on a resolution adopted by stockholders in 1933 authorizing the directors to redeem. It seems likely that this provision can be suspended at any time by a majority vote of stockholders, if not by action of the board of directors alone. The charter of Wellington Fund, Inc., is likewise silent as to redemption rights, the provision being merely incorporated in the corporation's by-laws, which may be amended at will by the board of directors. Spencer Trask Fund, Inc., and Premier Shares, Inc., have no redemption provisions in their certificate of incorporation, the former setting forth the redemption privilege in a contract between itself and the fund manager, the latter in an indenture pursuant to which the shares have been issued. Quarterly Income Shares, Inc., and Maryland Fund, Inc., provide in their certificates of incorporation that they will redeem their shares only until they are listed on a stock exchange (in any city of 2,000,000 or more population) and thereafter if the board of directors permits. It is our understanding that both companies have wholly or partially suspended redemption, after having listed their shares on the Chicago Board of Trade.

Supplementing the restrictions placed on redemption privileges by the provisions of charters, and the discretion to affect such privileges adversely by the failure to safeguard them through appropriate provisions in charters, are the further restrictions arising from the statutes of the States under which the various corporations have been, or may be, organized. At common law a corporation could ordinarily not purchase its own stock if its capital was impaired or if such purchase would result in an impairment of capital. In many States this is still the rule; New York, for example, has made it a penal offense for directors to permit the repurchase of their corporation's shares "out of any of its funds except surplus." [12] Open-end corporate investment companies subject to such State laws obviously must cease to redeem their shares whenever surplus is exhausted.

In order to circumvent this restriction, many corporations employ the expedient of allocating a large part of the consideration received from the sale of their stock to paid-in surplus account. This expedient is not, however, always available; and even where available is apparently not always taken advantage of. In several States paid-in surplus cannot be created;[13] in others, it is limited to a fixed percentage of the consideration received or otherwise;[14] and such restrictions seem to be the trend of modern corporation law.[15] In still other cases the use of paid-in surplus for repurchase of shares is restricted or prohibited.[16]

That the possibility of restrictions on redemption of stock is not ephemeral is evidenced by the fact that State Street Investment Corporation had a capital impairment at the end of 1930 of $2,700,000, and at the end of 1931 of more than $6,000,000.[17]

State Street Investment Corporation was not forced to suspend its stock repurchases when its capital was impaired, because under decisions of Massachusetts' courts a corporation may repurchase its own shares even though capital is impaired, so long as it is able to meet its debts and obligations as they mature.[18] However, had this company been subject to the laws of Delaware, as 14 of the present open-end investment corporations are, it would seem that the redemption

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[11] State Street Investment Corporation; Spencer Trask Fund, Inc.; Fidelity Fund, Inc.; Premier Shares, Inc. It has been frankly admitted by at least 1 open-end company (Maryland Fund—see letter of June 19, 1939) restrictions are limited to 60 days only in order not to lose the tax preference granted to mutual investment companies by the Revenue Act of 1938 (secs. 361, 362). The regulations of the Commissioner of Internal Revenue define a mutual company as a company whose shareholders are entitled to redemption within 60 days, even though such privilege may be further suspended on account of emergencies, etc. (sec. 19–361–2, regulations 103, par. D).

[12] Penal Law of New York, sec. 664. Restrictions on purchases out of capital are also found in Delaware, Michigan, Nevada, Arkansas, Florida, Indiana, Pennsylvania, Rhode Island, Tennessee, West Virginia. Under Kentucky law (sec. 544), shares may be repurchased only to prevent loss on a debt previously contracted and may not be held longer than one year. Connecticut (sec. 3423) requires a three-quarter vote of stockholders "unless to prevent loss on a debt previously contracted."

[13] Florida (sec. 6547) and Indiana (sec. 1 h). Cf. Virginia (sec. 3840).

[14] Michigan (sec. 20) requires the capitalization of at least 50 percent of the consideration received for shares without par value. Canada (sec. 12 (7)) limits paid-in surplus to 25 percent of the consideration received. California, Colorado, Minnesota, Pennsylvania, and others provide that the consideration received for preferred stocks must be credited to capital.

[15] See Hills, Model Corporation Act (1938), 48 Harv. Law Rev. 1334.

[16] Illinois (sec. 6) prohibits purchase of shares from paid-in surplus. California (sec. 342) and Minnesota (sec. 21) limit purchases to earned surplus except in special cases.

[17] Reply to Commission's Questionnaire for State Street Investment Corporation, Pt. II, Ex. A, Schedule 20.

[18] See *Crimmins & Pierce Co.* v. *Kidder Peabody Acceptance Corporation*, 185 N. E. 383, 83 A. L. R. 1122.

feature of outstanding certificates woudl have been rendered nugatory by law until capital impairment was eliminated.[19]

The Maryland law, although preserving the general rule that a corporation may not purchase or redeem its stock except out of surplus, has made a specific exception for investment companies. While this would seem to make permissible repurchases out of capital, the effect of this provision is offset by the fact that the charters of all the open-end companies incorporated in Maryland stipulate that they will redeem their stock "to the extent that they have surplus available, and out of such surplus."

If a corporation is required to resort to a reduction in capital in order to create surplus out of which shares may be repurchased, then complications of various kinds are met. Approval of stockholders is necessary, in some cases (such as Maryland) by a two-thirds vote. Moreover, the statutes of some States place restrictions on purchases of shares from "reduction" surplus or from any surplus except earned surplus.[20]

CONCLUSION

It seems doubtful, in the light of what has been said above, whether the provisions of section 22 (d) (1) giving the Commission power to prohibit suspension of the redemption privileges of redeemable securities is broad enough to protect the investor adequately. Obviously, the Commission could not prohibit the suspension of the redemption feature of a redeemable security if the corporation's capital is impaired and the State of incorporation prohibits repurchases under such circumstances. In order for the Commission to ensure that a redeemable security actually is such, it should have the power to supervise the wording of trust indentures and certificates of incorporation in respect to the redemption provision. Under the Barkley bill, it received such powers for trust indentures generally. There would seem no valid reason to omit them in the present bill.

REDEMPTION PROVISIONS OF OPEN-END CORPORATIONS

1. Incorporated Investors (Massachusetts corporation, 1925): Will repurchase on third day after tender.
2. State Street Investment Corporation (Massachusetts corporation, 1924): Nothing in charter or bylaws, but by vote of stockholders, January 31, 1933, corporation to repurchase shares offered, the liquidating value less $1, providing always that the corporation will not redeem if payment for stock would render corporation insolvent or would impair any reserves for liabilities and charges. The corporation reserves right to demand written notice, make payment within 60 days, and deliver assets in kind in lieu of cash.
3. First Investment Counsel Corporation (Massachusetts corporation): Golder may require the corporation any time after 30 days to purchase the shares, provided that all liabilities and charges of the corporation shall first be secured by setting aside assets sufficient to secure the payment thereof * * * and such payment shall not impair the reserves for liabilities and charges. The determination by the directors of the sufficiency of any reserves, and their appraisal of the stock to be purchased, etc., shall be final and conclusive. Redemption may be postponed for a period not exceeding 26 days.
4. Loomis, Sayles Second Fund, Inc. (Massachusetts corporation, 1934): Corporation required to redeem to the extent it has funds and/or assets legally available, but may defer such payment for 60 days. No transfer of stock can be effected without first offering same to the corporation at liquidating value and corporation shall have 60 days to accept.
5. Third Investment Counsel Corporation (Massachusetts corporation, 1929): Required to redeem any time after 30 days, as of a date not more than 16 days later than the date of surrender, payment to be made 10 days later, less 1 percent.
6. R. B. C. Fund, Inc. (Massachusetts corporation, 1929): Will redeem within 10 days of offer and pay within 10 days of appraisal.
7. Fidelity Fund, Inc. (Massachusetts corporation, 1930): Directors will repurchase class A upon demand at liquidating value less 2 percent.

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[19] By section 19 of the Delaware corporation law every corporation is empowered to purchase its own stock, but not if such purchase would impair the capital of the corporation. An exception is made in the case of preferred or "special" stock subject to redemption, but the term "special stock" would seem not to contemplate the securities of a company with a single class of stock, such as is found in most open-end companies (see sec. 14).

No attempt was made to study the relative size of the surplus at present existing in the 14 Delaware corporations. However, in the case of American Business Shares, it was noticed that paid-in surplus is scarcely larger than capital—and this despite the fact that a reduction in capital has already been effected.

[20] See the provisions of California, Minnesota, and Illinois cited supra, note 14.

8. Quarterly Income Shares, Inc. (Maryland corporation): Will repurchase—until shares of its capital stock are listed on an exchange, New York Curb, Boston, Chicago, or any other 2,000,000 or more—and thereafter if the board of directors permits, to the extent that the corporation shall have surplus available for the purpose, and out of such surplus, if the New York Stock Exchange is open.

9. Dividend Shares, Inc. (Maryland corporation): Will repurchase to the extent that the corporation shall have any surplus available for such purpose and out of such surplus, in 4 days.

10. Maryland Fund, Inc. (Maryland corporation, 1934): Will redeem in 3 days at liquidating value, to the extent that the corporation shall have surplus available for the purpose and out of such surplus, until stock is listed on an exchange (in any city of 2,000,000 population) and thereafter in the discretion of the board of directors, but excluding the period that the New York Stock Exchange is closed.

11. Bullock Fund, Ltd. (Maryland corporation, 1932): Will redeem in 5 days to the extent that corporation shall have any surplus available for such purpose, and out of such surplus.

12. Income Foundation Fund, Inc. (Maryland corporation, 1934): Stockholders entitled to require the corporation to redeem to the extent the corporation shall have any surplus available for such purpose and out of such surplus, if New York Stock Exchange is open.

13. Nation-Wide Securities Co. (Maryland corporation, 1932): Will redeem to the extent that corporation shall have any surplus available for such surplus, and out of such surplus, if New York Stock Exchange is open.

14. American General Equities, Inc. (Maryland corporation, 1931): Will redeem at liquidating value on next day that New York Stock Exchange is open.

15. Spencer Trask Fund, Inc. (Delaware corporation): Charter merely empowers board of directors to repurchase stock at 99 percent, payment in 60 days in cash or kind, provided the corporation has assets legally available for such purpose. However, contract between corporation and the fund's manager provides that the corporation will purchase stock tendered provided it has assets legally available for such purpose * * * after setting up such reserves as may be approved by the board of directors, in its uncontrolled discretion.

16. Selected American Shares, Inc. (Delaware corporation): Required to repurchase to the extent that it shall have any surplus available for such purpose and out of such surplus to purchase stock at the liquidating value thereof; but redemption suspended for the period that the New York Stock Exchange or other exchange on which securities are listed is closed.

17. Commonwealth Investment Co. (Delaware corporation, 1932): Will redeem within 14 days of offer, at net asset value as of any date within 7 days following deposit of certificate, to the extent, and only to such extent, of the funds which the corporation at the time of purchase may legally employ for such purpose, but redemption privilege suspended for the period that New York Stock Exchange is closed.

18. Supervised Shares, Inc. (Delaware corporation, 1932): Will purchase in 5 days, but only in the event and to the extent that the corporation has assets legally available for such purpose, and while New York Stock Exchange is open.

19. American Business Shares, Inc. (Delaware corporation, 1932): A continuous market for its shares shall be maintained based on their current net asset value less a discount of 2 percent, to the extent of the assets of the corporation legally available therefor. (Paid-in surplus, approximately equal to capital, but a 50-percent reduction in capital was necessary.)

20. General Capital Corporation (Delaware corporation, 1929): Will redeem in cash or kind within 10 days.

21. Fundamental Investors, Inc. (Delaware corporation, 1932): Will redeem in cash or kind, provided it has assets legally applicable to the purchase of own shares, if New York Stock Exchange is open.

22. Investors Fund of America, Inc. (Delaware corporation, 1933): Will redeem to the extent the corporation has surplus available for the purpose and out of such surplus, if New York Stock Exchange is open.

23. Investors Fund C, Inc. (Delaware corporation, 1930): Will redeem out of any assets legally available therefor, on any day New York Stock Exchange is open for business in cash or kind.

24. Equity Fund, Inc. (Delaware corporation, 1932): Will redeem within 4 days if New York Stock Exchange is open, at liquidating value less 2 percent, to the extent it has assets that under the laws of Delaware may be lawfully used for the purchase of its own shares of stock.

25. Group Securities, Inc. (Delaware corporation, 1933): Will redeem in 3 days if New York Steck Exchange is open, utilizing for the purpose earned the paid-in surplus in such proportions as will maintain the same proportionate interest but merely by resolution of the board of directors.

26. Premier Shares, Inc. (Delaware corporation, 1930): Nothing in charter 'ndenture (expired February 1, 1490) provides that company will redeem within 5 days, less 2 percent valued within 4 days after delivery, but company shall ιot be obliged to liquidate more than 15 percent of its stock in any given calendar month, thus carries over to next months. May suspend liquidation for 60 days.

27. Wellington Fund, Inc. (Delaware corporation, 1928): Nothing in charter bylaws (amendable by directors) states corporation will redeem in 5 days if it has assets legally available for such purpose, if New York Stock Exchange is open.

28. Administered Fund Second, Inc. (Delaware corporation, 1934): Required to repurchase within 3 days so long as it has sufficient funds available for such purpose, excluding days when New York Stock Exchange is closed.

29. United Gold Equities of Canada, Ltd. (Canadian corporation, 1933): Will redeem, but only in the event and to the extent that the company has any surplus available for such purpose, if the Standard Stock and Mining Exchange is open.

30. Canadian Investment Fund, Ltd. (Canadian corporation, 1932): Holder of "special shares" entitled at any time to require company to redeem to the extent that company has surplus available for such purpose and out of such surplus.

THE MARYLAND FUND, INC.

(Maryland)

JERSEY CITY, N. J., *March 27, 1940.*

Mr. DAVID SCHENKER,
Counsel, Investment Trust Study, Securities and Exchange Commission, Washington, D. C.

DEAR SIR: In response to your letter of March 22, I am enclosing copy of letter sent to the Securities and Exchange Commission under date of February 21, 1940, outlining present status of The Maryland Fund with respect to the repurchase of its own stock. We were derelict in that we did not send a copy of this communication to you.

Under date of June 20, 1937, I filed with your body a memorandum, the essentials of which are reproduced on the attached sheets. In this memorandum, written more than 2½ years ago, I set forth some of our ideas in connection with the dangers attending a deposit or repurchase liability of an investment fund. A portion of this memorandum was reproduced on page 27 in part 3, chapter III, of your report on investment trusts and investment companies.

The original charter of The Maryland Fund provides that the fund could be relieved of its repurchase or deposit liability after listing of the shares. This provision was inserted in the charter when the fund was brought out in 1934, because experience convinced us of the danger to all stockholders of a fund where the repurchase liability is present.

There is no doubt in my mind but that we failed to effect many sales because we did not have this liability and that many of the sales made were harder to make than they would have been had this safeguard not been present, but I am convinced that time will prove the wisdom of our position and justify our courage in accepting this selling handicap, to the end that permanent operation of the fund would be bettered.

You and your associates probably have a clearer picture of the investment fund field as a whole than anyone else, due to the minute study which you have given the field over the past several years. I think you will agree with us that the investment fund which is obligated to repurchase its own shares for cash on demand does not in fact have stockholders, but merely depositors. While the deposit liability is not strictly comparable with that of a commercial bank, there is, nevertheless, an analogy. It has always seemed to us that if an investment fund is to have the deposit liability of a commercial bank, it should confine its investments in large part to highly liquid items, such as those carried by a commercial bank, and should also keep a large cash position. A large cash position and a highly liquid portfolio would not be consistent with the goal of an investment fund. Therefore, we maintain that investment in a group of common stocks, coupled with a repurchase or deposit liability, is contradictory, and over a period of time will not prove workable in the best interests of stockholders.

When a fund is actively being sold, cash coming in from the sale of newly created shares is ordinarily sufficient to take care of the repurchase of outstanding shares

offered the fund for redemption. When the selling period is over, however, this situation no longer obtains, and it is necessary that the fund maintain sufficient assets in cash to take care of the repurchase liability, or that the portfolio be constantly shifted and earning assets sold off to raise cash to meet this deposit liability.

If the repurchase or deposit liability is on demand, or substantially so, and without a long period of grace, it seems to us that the tendency will be for a fund to sell off its more marketable assets in order to raise cash to meet its deposit or repurchase liability, with the result that stockholders loyal to the fund ultimately may find themselves owners of assets of less than average marketability.

We have had letters objecting to the removal of this liability from both stockholders and dealers. Generally speaking, the stockholders have appeared to be satisfied after an explanation somewhat similar to this letter. We say this because either we have heard further from such stockholders, or have had letters from them expressing satisfaction. In the case of dealers, the larger and better established dealers have not been upset, and in some cases have expressed approval of the action. In the case of certain small dealers there has been a very strenuous kick, based in some cases on a bona fide disapproval, but in other cases, in our honest judgment, based on the fact that their opportunities for trading out have been restricted.

Yours respectfully,

THE MARYLAND FUND, INC.
By ROSS BEASON.

[Copy to dealers as information]

THE MARYLAND FUND, INC.

(Maryland)

JERSEY CITY, N. J., *February 21, 1940.*

Re: The Maryland Fund, Inc. File 1–3035.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D. C.

GENTLEMEN: Pursuant to Rule X–13A–6 under the Securities Exchange Act of 1934, we transmit to you herewith an original and two (2) duplicate originals of "Form 8–K for Current Reports" in connection with the registration of the Maryland Fund, Inc., on the Board of Trade of the city of Chicago.

We had planned to make this filing at the end of the calendar month, as is customary in those cases requiring the use of Form 8–K. We are filing this before the end of the month because we plan to notify dealers of the change, but hesitate to do so in advance of notification to you.

Under the charter and under the prospectuses under which the stock of the Maryland Fund, Inc. was sold, the board of directors had the right, after the stock was listed as outlined in the prospectus, to withdraw the provision whereunder a shareholder might demand repurchase of his shares by the fund. Stock of the Maryland Fund, Inc. was listed on the Chicago Board of Trade on June 24, 1938. On June 7, 1939, the directors withdrew the right of resale to the fund, but instituted a regulation whereunder stockholders might deposit their shares with the fund, the liquidating value or repurchase price to be determined on the forty-eighth calendar day after deposit, and payment for the shares, less a discount of 3 percent, to be made within 3 full business days thereafter.

On February 15, 1940, the board of directors rescinded the regulation adopted on June 7, 1939, so that there is now no right of resale to the fund by shareholders.

Since no newly created shares have been issued since June 7, 1939, and since substantial repurchases by the fund have reduced outstanding shares since that date, it is believed that in the normal course of events a satisfactory secondary market can be created and maintained for the shares now outstanding, particularly so since elimination of the repurchase of shares by the fund automatically eliminates the 3 percent discount referred to.

One duplicate original of this report has been forwarded to the Board of Trade of the City of Chicago.

Respectfully yours,

B. E. LAWSON, *Vice President.*

RAY, JOHNSON & Co.,
Sunbury, Pa., July 19, 1939.

DAVID SCHENKER,
Counsel, Investment Trust Study,
Securities and Exchange Commission, Washington, D. C.

DEAR SIR: We are in receipt of your reply to our letters concerning the recent action of The Maryland Fund with respect to the 48-day liquidation provision.

All the information contained in your letter having as its origin The Maryland Fund, Inc., was known to us as this same information was given to all dealers, and we believe to all holders of the stock.

We, evidently, did not make ourselves entirely clear in entering our protest with your Commission. We realize that it is not the intention of the fund to liquidate, in fact the 48-day liquidation period was placed upon all outstanding shares to avoid liquidation.

The main point we wanted to bring to your attention was that these shares were sold by us upon information from the distributors of this stock, and with literature prepared, either by the fund itself or the distributors, which, regardless of what the official prospectus said concerning this provision, definitely and boldly stated that shares would be accepted for liquidation against next-day delivery without charge.

We realize that the prospectus approved by your Commission is the official description of the securities being offered, and that in using a prospectus they complied with your requirements. We do, however, feel that your requirements were evaded in other literature used in connection with the sale of these shares, which stated something as a fact that which was contrary to the charter provisions as outlined in the prospectus. In this literature they did not say that under the present set-up the stock would be liquidated immediately without charge, and that such a provision was subject to change as more fully outlined in their official prospectus, rather, they stated this condition as a fact.

We are not in a position to know whether the above procedure is contrary to the requirements of your Commission, but we still feel that whether or not it is, it most certainly has adversely affected the market for these shares with the holders being required to take this loss should they desire to liquidate immediately.

Very truly yours,

RAY, JOHNSON & Co.

EXCERPTS FROM LETTER OF ROSS BEASON, PRESIDENT OF THE MARYLAND FUND, TO DR. GOURRICH

The practice of liquidating to cash has four major weaknesses:

(*a*) It encourages and practically forces the use of unsound expedients in the matter of portfolio selection and cash position;

(*b*) It encourages trading from one fund to another, frequently at the expense of and to the hurt of the investor;

(*c*) It may penalize the investor who stays with a fund which is being looted by some competitive fund through trade-out operations, and in effect puts a premium on trade-outs; and

(*d*) It forces management to sell highly marketable securities and retain less marketable securities to obtain cash to meet liquidations.

Unfortunately during the selling period for an open-end fund where the liquidation clause is present it is necessary from a practical standpoint, or rather from a selling standpoint, to have the portfolio composed of companies more or less well known by name to the average investor, and consequently made up of a list found in similar competing funds. After the selling period is over, it is necessary to continue along much the same lines to avoid criticism and stop trade-out arguments of competitors.

Take the case of an investment fund with, say, $100,000,000 of assets. If we should run into another period such as we did in late 1929 and the management should appraise the future and get into a cash position, they would promptly be penalized for their efforts because the assets of this particular fund being in cash and would show no shrinkage when the market fell and the shares of the fund would remain at a high level, whereas other securities would show a drastic decline. It is fundamentally true that people sell good securities to

protect poor securities, and the result would be that the fund would be liquidated and a penalty put upon the foresight and acumen of the management for having appraised market action. Indeed, with a fund so large it would take several months to get into a cash position, and if the market were showing a steady rise up to the time of the break, as it did substantially in 1929, the competitors would call attention to the fact that shares of this particular fund were not increasing in value as fast as the shares of a less well-managed fund which was not getting into a cash position in anticipation of the market break. This again would cause liquidations. In event sincere management believed that a break was imminent and got into a cash position and the break did not materialize, the competitors would use this as an argument to get out of that particular fund because they had not called the turn.

Any way you look at it the management of funds with liquidating clauses are more or less forced to follow one another like sheep instead of giving the best operation which their studies and efforts may suggest.

Many sound and sizable corporations with fairly large capital issues outstanding do not have a broad market. It is a human thing for management to sell those securities which the market will take and retain those which have a thinner market in order to raise cash to meet liquidations, and carried to an extreme degree this would inevitably result in a portfolio of less-than-average marketability if any substantial liquidations took place. Believing as I do that the Securities and Exchange Commission will handle the situation from a realistic standpoint, I feel sure that this particular feature is fully understood.

Actually, the liquidation clause is a contradiction in a management fund. It represents a survival from the fixed trust, when the investor had no market for his securities except through liquidation. Shares of fixed trusts could not be listed because they were not issued in one shares and multiples but were issued in fixed denominations, and the investor who sold was held to mere liquidating value or all he could in event of a sale.

A fixed trust was merely a warehouse receipt, and might be likened to a situation where a ham, a sack of flour, a barrel of sugar, etc., were deposited with the warehouseman and a receipt issued therefor, which receipt could be exchanged for the warehoused property. The effort to apply warehouse-receipt practice to corporation capital-stock issues is not sound. If the shares of an investment fund be listed on some recognized exchange, the law of supply and demand will work, just as it does in other corporate securities.

Mr. L. M. C. Smith. Just in this respect, and with regard to a statement by one of the gentlemen, who testified regarding the stockholders' being completely happy, I can say that the other day we got a letter—I shall not mention the company, but it is the company of one of these gentlemen here: He said:

With regard to this company, I paid these people $8,300 for 100 shares of their stock on September 26, 1929. The stock's present value is $1,550—a capital loss of over 80 percent. The stockholder has no vote nor voice in the management of the company. I am advised that their management fee is excessive.

I sincerely hope you will investigate this firm.

Very truly yours.

This is dated February 2, 1940.

We have a number of other stockholders who expressed the same sort of sentiment.

Mr. Schenker. And this is important, Senator, on the question of the supplemental literature—where this great charge of bureaucracy was made, where they charged that we are going to censor every letter they send out. This letter is from an investment-securities dealer which is annexed to the memorandum on suspension of redemption. He said:

I have sold a great many of my customers the shares of Maryland Fund.

The main point we wanted to bring to your attention was that these shares were sold by us upon information from the distributors of this stock, and with literature prepared, either by the Fund itself or the distributors, which, regard-

less of what the official prospectus said concerning this provision, definitely and boldly stated that shares would be accepted for liquidation against next-day delivery without charge.

We realize that the prospectus approved by your Commission is the official description of the securities being offered and that in using a prospectus they complied with your requirements.

We do, however, feel that your requirements were evaded in other literature used in connection with the sales of these shares, which stated something as a fact that which was contrary to the charter provisions as outlined in the prospectus.

Now, you can go ahead and say, "Well, he has a lawsuit and can sue them." However, we feel that the fact that it is an open end company does not make it any different from the closed end company: It should be subject to the same supervision, the same requirements, and the same safeguards for the protection of the investor.

Now just one other thing: There was some discussion here by the investment counselors with regard to title 2 which provides for their registration and regulation. In listening to what they had to say about those provisions for registration and regulation, I almost forgot the size of the title of the bill providing this regulation; I thought it must be quite a substantial affair.

However, the Senators will see that the title merely requires registration, and seeks to prevent frauds, and keep out jailbirds and security racketeers.

The approach these people have taken to the problem is curious. As I see it, it goes something like this: They designated themselves the Board of Regents of New York. They conferred upon themselves the degree of Doctor of Investment Counselors. They made themselves a profession, and said, "We are a profession; we have a confidential relationship with our client and therefore you cannot regulate us and cannot ask us any questions."

I know that in order to become a lawyer I had to go to public school, high school, college, law school, pass a bar examination, submit character evidence, have my character examined, and pass the Appellate Division. In addition, my conduct is subject to continuous scrutiny.

Why, tomorrow morning I can become an "investment counselor." All I have to do is just to get a printer to print some cards, "David Schenker, Investment Counselor." That immediately makes me an investment counselor.

Does that mean that I can take umbrage when some governmental agency wants to ask me some questions? The approach of the representatives of investment counsel is a peculiar one.

In the first place, we discussed this entire legislation not only with the people who were down here but also with investment counsel who are also in the investment-banker business and the brokerage business. They did not appear here. It is a queer thing that these people in the investment-banker business and the brokerage business, who did not appear here are subject to the S. E. C. regulation because they have to register under the Maloney Act as brokers and dealers. They evidently were not frightened to death about our peeking in their books and finding out the names of their private clients. They did not even show up.

Then there is another curious thing, Senator, that those people who are subject to supervision by some authoritative body of some kind, such as securities dealers or investment bankers have to register

with us as brokers and dealers. People, who are brokers and members of stock exchanges and are supervised by the stock exchanges. Curiously enough, the people in the investment-counsel business who are supervised are not eligible to membership in the investment counsel association; because the association says that if you are in the brokerage or banking business you cannot be a member of the association.

So the situation is that if you take their analysis, the only ones who would not be subject to regulation by the S. E. C. would be the people who are not subject to regulation by anybody at all. These investment counselors who appeared here are no different from the over-the-counter brokers and dealers or the members of the New York Stock Exchange. All we ask them to do is file a registration statement which asks "What is your name and address, and have you ever been convicted of a crime?"

"If you have been convicted of a crime, you cannot be an investment counselor and you cannot use the mails to perpetrate a fraud."

That is the extent of the proposed law.

I should like to introduce as an exhibit the digest of the laws of the various States which require investment counsel to register. California had no difficulty with registration. Also I should like to submit a report of the Research Department of the Illinois Legislative Council, which has had a great deal of difficulty with that problem. We should like to make that memorandum a part of the record on investment counselors.

Senator Hughes (presiding). All right; it will be put in.

(Statement entitled "State Regulation of Investment Counsel Firms" is as follows:)

State Regulation of Investment Counsel Firms

Federal regulation of investment counselors as such does not exist at the present time.[1] Several of the States require that persons who furnish investment counsel advice be registered with the State Securities Commissioners.[2]

1. CALIFORNIA

The State of California amended its Corporate Securities Acts in 1931 to provide for the registration of investment counselors.[2a] The act broadly defines an "investment counsel" as follows:

"Every person or company other than a broker, who in this State, for compensation, engages in the business of advising others either directly or through publications or writings as to the value of securities or as to the advisability of investing in or purchasing of securities, and every person other than a broker or certified public accountant who issues or promulgates analyses or issues reports concerning securities; *Provided, however,* That said term shall not be construed to include any licensed, practicing attorney who renders or performs any of said services in connection with the practice of law."

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[1] However, sec. 17 (b) of the Securities Act of 1933 and sec. 15 of the Securities Exchange Act of 1934 contain provisions which may interdict to a liimted extent some of the activities of investment counselors.

[2] Some States which have no statutory regulation with respect to investment counselors do, however, recognize the importance of having such regulation. For example, the Illinois Legislature has at present pending before it a bill with respect to the regulation of investment counselors. In Massachusetts the State Securities Division is apparently attempting to regulate counselors as brokers. In Minnesota, the Securities Division, at the last session of the legislature, attempted to have a law passed giving the division some regulatory powers with respect to investment counselors as exist concerning brokers and security dealers. In Missouri, the State Securities Division has taken the position that investment counselors should register as dealers in securities, since on advising clients they are believed to act in some manner within the scope of the statutory definition of dealer. In Texas there is a recognition by the Securities Commission that there is need for some regulation to prevent counselors from also acting as dealers in securities, in order to afford unbiased advice. (Report of Research Department of Illinois Legislative Council on Statutory Regulation of Investment Counselors, September 1939.)

[2a] See Appendix F.

The registration application of the incestment counselors requires the following type of information: (*a*) The name and residence of the applicant; (*b*) the business reputation, experience, and education to qualify the applicant to act as an investment counsel and the training and background of the applicant who wishes to function as an investment counsel; and (*c*) the plan, character, and method of business.

The California Commissioner is emplowered by the statute to deny the application or revoke registration if either the applicant does not possess the requisite training and experience, or any officer, director, or member thereof has or is about to engage in any fraudulent transactions.[3]

2. CONNECTICUT

The State of Connecticut on May 12, 1937, passed a statute[4] which, like the California statute, required investment counsel organizations to register with the State Securities Commission. The Connecticut statute specifically excluded from the scope of its definition certain financial units such as banks, loan associations, etc. The bases for denial or revocation of registration are closely similar to those in the California statute.

3. ILLINOIS

Illinois, in its rules and regulations respecting the sale and disposition of securities, apparently supports the practice of permitting brokers and/or dealers to give investment counsel advice in addition to their usual transactions in securities.[5] The rule which applies to investment counselors, however, defines the standard of fiduciary obligation which should obtain in cases where such broker and/or dealer attempts to furnish investment counsel advice in those transactions. The provisions in this respect read as follows:

"Investment counsel or advice, whether by one specializing solely in rendering investment counsel or advice, or by a dealer or broker, incidental to usual transactions in securities, shall be strictly on the basis of fiduciary relationship between the counselor or advisor and the investor or prospective investor. In no event shall such counsel or advice be influenced or colored by the element of profit or compensation through the sale or trade-out of any security held by the investor. Any advice or counsel given to an investor respecting the position of a security held by such investor must be solely on the basis of interest or pecuniary profit to the investor. Any investment counselor who in any manner, whatsover, either directly or indirectly, places or assists in placing any contract for the purchase or sale of securities is held to be a registrant and must be qualified as provided by the provisions of the Illinois Securities Law."

4. MICHIGAN

The Michigan securities statute includes in its definition of "dealer" in securities one "who for any consideration acts as an investment counselor and advises the purchase and sale of securities." As a "dealer," therefor, he is required to be licensed by the State Securities Commissioner.[6]

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[3] Some information on the operation of the California Statute was supplied in a letter from the Securities Commissioner of California to the Commission. This letter reads, in part, as follows:

"Since the Corporate Securities Act was amended in 1931 to make provision for the licensing of Investment Counsels, the number of applications have been as follows:

1931	42
1932	105
1933	102
1934	97
1935	89
1936	113
1937 (January to April)	33

Our records disclose that during the period from August 1931 to April 1937, two investment counsel certificates have been suspended, 20 investment counsel certificates have been revoked and 101 investment counsel certificates have not been renewed. Each cercate expires on the 31st day of December of the year in which it is issued."

[4] See Appendix F.

[5] See Rule 15 of Illinois Rules and Regulations under the Illinois Securities Law effective December 31, 1938.

[6] In addition, Rule 14 of the Michigan Rules and Regulations adopted Jan. 1, 1936, is similar to the Illinois Rule 15, above cited, defining the standard of fiduciary obligation to be maintained by an investment counsel.

5. NEW HAMPSHIRE

The New Hampshire securities statute includes within its definition of "securities" "contracts of services and advice relating to investments, or membership in organizations or associations purporting to render such services or advice," which, in other words, describes the services of an investment counselor. A further provision of the act provides that "dealers in securities," which would thus include persons selling investment counsel advice, must register with the securities commission. The State Securities Commission has the authority under the statute to investigate the financial standing and reliability of a prospective dealer and to pass upon the advertising material to be used by such person in connection with his activities.[7]

6. OKLAHOMA

The State of Oklahoma, by an amendment to its Securities Act in May 1933, provided that only registered dealers may function as investment counselors,[8] but exempted lawyers and certified public accountants. Registration was conditioned upon the posting of a bond to account for customers' funds and securities and to satisfy judgments obtained by customers against the dealer in actions based on security transactions.

7. RHODE ISLAND

Rhode Island provides for the registration of brokers, and in the definition of broker includes every person who "for any cause acts as investment counsel and advises the purchase and sale of securities." [9]

State Statutes With Respect to Investment Counselors

CALIFORNIA

Definition.—The words "investment counsel" as used in this act shall include every person or company other than a broker, who in this State, for compensation, engages in the business of advising others either directly or through publications or writings as to the value of securities or as to the advisability of investing in or purchasing of securities, and every person other than a broker or certified public accountant who issues or promulgates analyses or issues reports concerning securities: *Provided, however*, That said term shall not be construed to include any licensed, practicing attorney who renders or performs any of said services in connection with the practice of law.

Registration of the investment counselor.—No person or company, other than a broker, shall act as an investment counsel until such person or company shall have first applied for and secured from the commissioner a certificate then in effect authorizing such person or company so to do. Every such certificate shall expire on the 31st day of December next after its issuance unless sooner suspended or revoked.

To secure such certificate, the applicant shall make and file in the office of the commissioner an application therefor in writing, verified by or in behalf of the applicant. In such application, the applicant shall set forth, in addition to such other information as may be required by the commissioner:

(1) The name, residence, and post-office address of the applicant;

(2) If a corporation, association, joint-stock company, or partnership, the name, residence, and post-office address of each of its managing officers, agents, or partners, as the case may be;

(3) A succinct statement of facts showing that the applicant and each of its managing officers and agents or partners, as the case may be, is of good business repute and possess the experience and education which would qualify him to act as investment counsel; and

(4) The general plan, character, and method in which applicant proposes to conduct its business.

If the applicant is a corporation or an association organized under the laws of any other State, Territory, or government it shall file with its application a copy of its articles of incorporation or association, together with a certificate executed

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[7] See State legislation *infra*.
[8] Ibid.
[9] Ibid.

by the proper officer of such State, Territory, or government, not more than 30 days before the filing of such application, showing that such applicant is authorized to transact business in said State, Territory, or government, and also in such form as the commissioner may prescribe its written instrument irrevocably appointing the commissioner and his successor in office its true and lawful attorney upon whom all process in any action or proceeding against it, arising out of or founded upon the fraud of such applicant in the conduct of its business as investment counsel, may be served with the same effect as if said corporation or association were organized or created under the laws of this State and had been lawfully served with process therein.

The commissioner shall examine such application for an investment counsel's certificate and shall make such further investigation of the applicant and its affairs as he shall deem advisable. If from such examination the commissioner shall be satisfied—

(a) That the applicant and its officers, directors, and members, if any, are of good business repute and in the opinion of the commissioner qualified by experience and education to conduct an investment-counsel business;

(b) That neither the applicant nor its officers, directors, or members, if any, have violated any of the provisions of this act or of chapter 226 of the statutes of 1923; and

(c) That neither the applicant nor its officers, directors, or members, if any, have engaged or are about to engage in any fraudulent transaction, he shall issue such certificate. Otherwise, he shall deny the application and notify the applicant of his decision: *Provided, however*, That if the only ground for such denial falls under subdivision (b) or (c) of this section, the commissioner may, in his discretion, waive such ground for denial and issue a certificate to the applicant if satisfied that in the particular case the application of either subdivision is purely technical and does not substantially affect applicant's honesty and integrity, and that the inability of applicant to meet either of these requirements will in no way interfere with a proper performance by the applicant of his duties as an investment counsel.

The commissioner may at any time temporarily suspend any investment counsel's certificate issued by him if he finds, after a hearing upon such notice as he, in his discretion, shall deem reasonable, that there exists any of the grounds hereinabove enumerated for the denial of an application for an investment counsel's certificate. If, at the expiration of 30 days from the date of such suspension, the certificate so suspended has not expired or has not been revoked, as hereinafter provided, it shall be deemed reinstated. The commissioner must revoke any investment counsel's certificate, if, after hearing upon notice, he shall find the existence of any of the grounds, hereinabove enumerated, for the denial of an application for an investment counsel's certificate: *Provided, however*, That such revocation shall be discretionary with the commissioner if the only ground for such revocation falls under subdivision (b) or (c) of this section and he is satisfied that in the particular case the application of either subdivision is purely technical and does not substantially affect applicant's honesty and integrity, and that the inability of applicant to meet either of these requirements will in no way interfere with a proper performance by the applicant of his duties as an investment counsel. (Deering, General Laws of California (1937), vol. I, act 3814, S. 2 (12), S. 9.)

CONNECTICUT

Definition.—The term "investment counsel" shall include any person, who, in this State, shall engage in the business of advising others, either directly or by mail or through publications or writings, as to the value of specific securities or as to the advisability of investing in purchasing or selling such securities, for a compensation or commission or at a profit, but shall not include any national banking association or Federal savings and loan association located in this State or any State bank and trust company, industrial bank, savings bank, or building and loan association under the supervision of the bank commissioner, nor any person registered as a "broker" under the provisions of chapter 212 of the general statutes, as amended.

Registration of the investment counselor.—Each registration of an investment counsel shall set forth, in addition to such other information as may be required by the commissioner, the following: (a) The name, residence, and post-office address of the registrant; (b) the form of organization under which registrant conducts business; (c) if such investment counsel be a corporation,

an association, a joint-stock company or a partnership, the name, residence, and post-office address of each of its directors, managing officers, agents, or partners, as the case may be, together with such information in respect to the business record or experience of each such direction, officer agent, or partner and such other information as may be required by the commissioner; (d) the general plan, character, and method by which the registrant proposes to conduct his business and the form of business he is engaged in or is transacting; (e) a statement as to whether such investment counsel or, if such investment counsel be other than an individual, whether any partner, principal, officer, director, or branch manager thereof has been convicted by a court of competent jurisdiction in any State or country of any criminal offense in connection with any transaction involving the sale or offer for sale of securities; or has been enjoined or restrained by order of any court, commission, or public official from selling or offering for sale securities in any State or county or continuing any practices in connection therewith, or been arrested or prosecuted for any violation of law involving securities in this or any other State, or been convicted of any criminal offense of any nature or sentenced to imprisonment in a jail or other penal institution, or, having applied for registration or having been registered or licensed as a dealer, broker, or salesman of securities in any State or country, has had such registration or license refused, suspended, canceled, or withdrawn, either by request or otherwise. If such investment counsel or any such partner, principal, officer, director, or branch manager has ever been convicted, restrained, enjoined, arrested, or prosecuted, or has had any registration or license refused, suspended or canceled, or withdrawn, by request or otherwise, such investment counsel's registration shall have incorporated therein complete details thereof.

The registration of an investment counsel shall be sworn to before a person qualified to administer oaths by the person making the same and shall state that the alleged facts therein contained are true of his own knowledge and, if such person be a partnership, such oath shall be made by a member thereof and, if such person be a corporation or any other form of an association, such oath shall be made by an executive officer thereof. Any person who shall make a false statement in such registration or in any sworn statement or affidavit attached thereto shall be subject to the penalties prescribed for violation of the provisions of section 1533c of the 1935 supplement to the general statutes and of the provisions of any other section of the general statutes violated thereby. Said commissioner may adopt forms to be used by persons registering as investment counsel as herein required, and shall furnish such forms to any person requesting the same, without charge.

Upon receipt of the registration of an investment counsel, accompanied by the fee required by this act, and upon compliance with the provisions of this act, the commissioner may make such further investigation of the registrant and his affairs as he shall deem necessary or advisable. Upon the completion of such examination or investigation, the commisisoner, shall, subject to his authority to refuse such registration as hereinafter provided, enter the name of such person on a register of investment counsel to be kept in his office, properly indexed and open to the public, provided no registration shall be so entered within five years after the date of a conviction of any criminal offense in connection with any transaction involving securities, or within 5 years after the date of the issuance of any permanent injunction or restraining order in connection with securities, or within 5 years after the cancelation of any license or registration as broker, dealer, or salesman, in this or any other State as a result of alleged fraudulent transactions on the part of any such registrant, or, if the registrant be a partnership or a corporation or any other form of an association, on the part of any partner, principal, officer, or director therefor. The commissioner is authorized to refuse to accept the registration of an investment counsel for any reason which is cause for the cancelation of such registration, or whenever the commissioner shall have reason to believe that such refusal is necessary to protect the public against fraud. The commissioner shall not issue any certificate or written evidence to any person registered as an investment counsel. Each person who has registered as an investment counsel, shall immediately file with the commissioner in writing any change of residence, mailing address, or place of doing business, or any other changes in such registration that may, from time to time, occur.

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If the commissioner shall be satisfied, either after an investigation or otherwise, that any person registered as an investment counsel (a) has violated

any of the provisions of this act; (b) has violated any of the provisions of said section 1533c; (c) has rendered advice of a fraudulent nature, with intent to perpetrate a fraud in connection with or relating to the purchase, sale, or continued investment in any security; (d) is in any way dishonest or is conducting or has conducted his business as investment counsel in a fraudulent manner or is about to engage in any fraudulent transaction; (e) has failed or refused to file such information with respect to the business or the facilities of the organization of such investment counsel as has been required by the commission, or (f) has made a material false statement in the registration, the commissioner, upon notice to such person and affording him an opportunity to be heard, may cancel such person's registration. Notice from the commissioner sent by mail in a sealed envelope, postage prepaid, to such person at his principal address, shall be deemed sufficient notice to such person. The commissioner shall not cancel the registration of any investment counsel except upon such notice to such person given as herein provided.

* * * * * * *

Each person registered as investment counsel shall pay to the commissioner for the use of the State an annual fee of fifty dollars. Any registration, unless sooner revoked, shall expire at midnight on June thirtieth next succeeding the effective date of such registration. Such fees shall be paid in advance and no person shall be deemed to be registered as an investment counsel unless he shall have paid the fee herein provided for. In addition to such annual fee, each person registered as an investment counsel shall pay the actual cost, as determined by the commissioner, of any investigation or examination made of such investment counsel's affairs under the provisions of said section 1537c, as amended, or any provision of this act, by or on behalf of the commissioner. (Connecticut, General Statutes (Supp. 1937), Ch. 212, Sec. 7470.)

MICHIGAN

Hereafter it shall be unlawful for any person to engage in the business of dealing in securities whether exempt from or included in the provision of such decision of this act without first procuring a license and continuing to be licensed therefore, as hereinafter provided, * * *. For the purpose of this act, any person who for any consideration acts as an investment counselor and advises the purchase and sale of securities, shall be deemed a "dealer" * * *. (Michigan, Public Acts of 1935, act 37, sec. 21.)

NEW HAMPSHIRE

Under this chapter dealer shall mean any individual, partnership, association, or corporation engaging in the selling or offering for sale of securities, except through the medium of, or as agent or salesman of, a registered dealer. But sales made by or in behalf of a resident of this state in the ordinary course of bona fide personal investment of his personal holdings, or change of such investments, shall not constitute such resident, or the agent of such resident, if not otherwise engaged either permanently or temporarily in selling securities, a dealer therein. A nonresident desiring to make such sale of his personal investments must first obtain the approval of the insurance commissioner.

Securities shall include all classes of stocks and shares, bonds, debentures, evidences of indebtedness and certificates of participation, certificates of warehousemen, rights and interests in land from which petroleum or minerals are, or are intended to be, produced, ship shares, and investment contracts in the form of a bill of sale, or any similar device, and contracts of services or advice relating to investments, or membership in organizations or associations purporting to render such service or advice.

* * * * * * *

No dealer in securities shall, in this State, by direct solicitation or through agents or salesmen, or by letter, circular, or advertising sell, offer for sale, or invite offers for or inquiries about securities, unless registered as a dealer under the provisions of this chapter.

Any dealer desiring registration shall file written application therefor with the insurance commissioner, accompanied by a registration fee of $25, the fee to be returned if the application is not granted.

The application shall be in such forms as may be prescribed by the commissioner, and shall state in writing the principal place of business, the name or style of doing business, and the address of the dealer, the names, residences, and busi-

ness addresses of all persons interested in the business as principals, officers, directors, or managing agents, specifying as to each his capacity and title, and the length of time during which the dealer has been engaged in the business.

The commissioner may examine or cause to be examined at the expense of the applicant or dealer the affairs and condition of a registered dealer in securities or an applicant who desires to become registered as such dealer. An applicant shall furnish in addition to the information required in the application such other documentary evidence of condition and responsibility as the commissioner may require, including without limiting the generality of the foregoing, authentic copies of articles of incorporation, partnership agreements, bylaws, balance sheets, and earning statements. By December 1 of each year every licensed dealer in securities shall furnish under the oath of such responsible member or members of the dealer's organization as the commissioner may require an annual financial statement for the period ending June 30 of each year, exhibiting with reasonable detail assets, liabilities, profit, and loss of the dealer for a period of 1 year upon a form to be furnished by the commissioner.

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The application filed with the commissioner for registration as a dealer shall be held for investigation for a period of 4 weeks from the date when the application reaches the commissioner.

Upon being satisfied of the applicant's good repute, financial standing, reliability, and right to public confidence, the commissioner may register the applicant as a dealer.

* * * * * * *

The commissioner may, unless furnished with satisfactory evidence as provided in the preceding sections, or in case of violation of any provision of this chapter, or in case of dishonest, deceitful, or fraudulent conduct on the part of any dealer in connection with the carrying on of the business, revoke such dealer's registration, and may, having reasonable cause to believe that such facts exist, suspend such dealer's registration until satisfied to the contrary. (New Hampshire, Public Laws, ch. 284, secs. 2, 6.)

OKLAHOMA

Registration of dealers and salesmen, requirements, bonds, fees.—No dealer or salesman shall engage in business in this State as such dealer or salesman or sell any securities, including securities exempted in section 4, of this act, except in transactions exempt under section 5 of this act, unless he has registered as a dealer or salesman in the office of the commissioner pursuant to the provisions of this section. No person other than a registered dealer, shall in this State, for a commission or compensation, act as investment counsel or engage in the business of advising others directly or through publications or writings as to the value of securities or as to the advisability of investing in or purchasing securities; provided, however, that this provision shall not be construed to include any licensed practicing attorney who renders or performs any of said services in connection with the practice of law or to any certified public accountant who issues or promulgates analysis or issues reports concerning securities.

Provided, that nothing in this act shall require such registration, for the sale of insurance, by agents, who are required to be licensed for such purpose by the commissioner of insurance.

An application for registration in writing shall be filed in the office of the commission in such form as the commissioner may prescribe, duly verified by oath, which shall state the principal office of the applicant, wherever situated, and the location of the principal office and all branch offices in this State, if any, the name or style of doing business, the names, residence, and business address of all persons interested in the business as principals, copartners, officers, and directors, specifying as to each his capacity and title, the general plan and character of business, and the length of time the dealer or salesman has been engaged in business. The commissioner may also require such additional information as to applicant's previous history, record, and association as he may deem it necessary to establish the good repute in business of the applicant.

There shall be filed with such application an irrevocable written consent to the service of process upon the commissioner in actions against such dealer in manner and form as hereinbefore provided in section 9.

If the commissioner shall find that the applicant is of good repute and has complied with the provisions of this section, including the payment of the fee

hereinafter provided, he shall register such applicant as a dealer upon his filing a bond in the sum of $5,000, running to the State of Oklahoma, conditioned that the dealer shall properly account for any
moneys or securities received from or belonging to another and shall pay, satisfy, and discharge any judgment or decree that may be rendered against such dealer in a court of competent jurisdiction in a suit or action brought by a purchaser of securities against such dealer in which it shall be found or adjudged that such securities were sold by the dealer in violation of this act or that such purchaser was defrauded in the sale of such securities. Such bond shall be executed as surety by a surety company authorized to do business in this State; or such bond may be a personal bond, provided that the dealer shall keep on deposit with the commissioner, as surety, securities exempt under subdivisions (a), (b), or (e) of section 4 of this act of the marketable value of at least the amount of such bond, which said securities shall be returned to such dealer when the liability under such bond has terminated or been satisfied. One recovery upon such bond shall not void same, but it shall be subject to successive suits and recoveries until the penalty thereof is exhausted; provided, that the aggregate liability of the surety on such bond for all such suits and recoveries shall not exceed the sum of five thousand ($5,000.00) dollars; and, provided further, that no action shall be brought for recovery under the provisions of this act after two years from the date of the act or transaction in violation thereof. Upon suits being filed to recover damage from a dealer who has executed a bond, with a surety company as surety thereon, in excess of the amount of any such bond, the commissioner, by written notice served upon such dealer, may require such dealer to give a new bond, and if the same is not given within twenty (20) days after such service the commissioner may revoke the registration of such dealer. (Oklahoma Statutes, title 71, ch. 5, S. 41.)

RHODE ISLAND

The term "broker" shall mean and include every person, other than a salesman, who in this State engages, either for all or part of his time, directly or through an agent, in the business of selling any security, whether issued by himself or another person, or in the business of purchasing or otherwise acquiring such securities for another with the purpose of reselling them, or of offering them for sale to the public, for a commission or at a profit, or for any consideration acts as an investment counselor and advises the purchase and sale of such securities.

No person shall sell securities as a broker or salesman respectively within the State unless he is registered as such with the chief of division of banking and insurance. Said chief shall not register any person as a broker or salesman unless said chief shall determine that the character of such person is such that he will conduct the business of broker or salesman without fraud. If demanded by said chief, any person desiring to register as a broker or salesman shall furnish the names of three responsible citizens of Rhode Island who can vouch as to the character of the applicant. If it appears to said chief that any person registered as a broker or salesman is violating any of the provisions of this chapter or is conducting his business as broker or salesman in a fraudulent manner or is violating any of the regulations of said chief, said chief, upon notice to such person, shall cancel such person's registration.

Upon the finding by said chief that a person may act as a broker or salesman within the State, the name of such broker or salesman shall be entered in the register of brokers or salesmen; but the finding of said chief that a person shall not act as a broker or salesman, and that his name shall not be entered in or should be cancelled on the register shall be in the form of an order to that effect. Where the registration of a person as salesman or broker is canceled for cause said chief shall so note upon the register.

Every person applying for registration as a broker or salesman or filing any lists or information or making application to said chief to sell securities, shall file with said chief his permanent mailing addresses and such changes thereof as may thereafter from time to time occur. Notice from said chief sent by mail in a sealed envelope, postage prepaid, to such person at such address shall be deemed sufficient notice to such person. Said chief shall not suspend or forbid the sale of securities or cancel the registration of any broker or salesman except upon notice to such person given as aforesaid.

Every such broker who is not a resident of this State, shall, at the time of filing his application for registration, also file a written instrument appointing

said chief in his name of office and his successor in office to be the true and lawful attorney of such nonresident broker in and for this State upon whom all lawful process in any action or legal proceeding against said nonresident broker may be served with the same effect as if said nonresident broker were a resident of this State. Said power or attorney shall stipulate and agree on the part of said nonresident broker that any lawful process against said nonresident broker which is served on said attorney shall be of the same legal force and validity as if served on said nonresident broker, and that the authority shall continue in force so long as any liability remains outstanding against said nonresident broker in this State. A copy of such appointment, duly certified by said chief, shall be received in evidence in all courts in this State. Service from such attorney shall be deemed sufficient service upon the principal. Whenever the said chief shall have been duly appointed attorney to receive service of all lawful process for any such broker, said chief shall forthwith forward by mail, postage prepaid, a copy of every process served upon said chief to said broker at his last known post-office address. For each copy of process said chief shall collect to and for the use of the State the sum of $2, which shall be paid by the plaintiff or moving party at the time of such service, to be recovered by him as part of his taxable costs if he succeeds in his suit or proceeding. The term process when used herein includes any writ, summons, petition, or order whereby any suit, action, or proceeding shall be commenced or any other process, original or mesne, in connection therewith. (Public Laws of Rhode Island, 1935–36, ch. 2339, secs. 5, 6.)

(Memorandum entitled "Statutory Regulation of Investment Counselors—by Research Department, Illinois Legislative Council," is as follows:)

STATUTORY REGULATION OF INVESTMENT COUNSELORS, BY RESEARCH DEPARTMENT, ILLINOIS LEGISLATIVE COUNCIL, SPRINGFIELD

These reports are intended to provide a factual source of information with regard to problems concerning which the general assembly may be called upon to act. The research department of the legislative council is engaged in objective fact finding under the general supervision of the members of the council, who also serve in the general assembly. Recommendations for the consideration of proposed legislation or particular policies are not made by the research department.

Those who have funds to invest, whether the sums be large or small, face the difficult task of finding trustworthy guides to their investment problems. Some types of investment information have been available for many years, but the growth of investment services generally has been most marked in the period since 1930. This has been explained by one writer who points out that the stock-market collapse of 1929 destroyed what he calls the restful supposition that sound investments could be safely put away and forgotten. The same writer adds that every intelligent investor today knows that insecurity prevails and, accordingly, looks for some leadership in his investment problems.[1] There are a great variety of services to which the investor may turn for advice and leadership.

Giving precise meaning to the term "investment counselor" presents many difficulties, partly because there exist few statutory definitions, partly because the concept of the "profession" is comparatively new, and also because even those who engage in investment counseling have reached no general agreement as to the exact scope of their activities. In the broadest sense, investment counseling is the giving of advice concerning the purchase or sale of securities. This is a service that is rendered to some extent by a great variety of organizations and individuals, including investment houses, brokers, banks, attorneys, journals, and statistical agencies. In a narrower and more idealistic sense, an investment counselor is one who, for a valuable consideration, devotes his time exclusively "to render to clients, on a personal basis, competent, unbiased, and continuous advice regarding the sound management of their investments."[2]

[1] Frank P. Breckinridge, "Investment Counsel—Faith or Folly," Commerce, October 1936, p. 17.

[2] Securities and Exchange Commission, Report on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services (August 17, 1939), p. 28.

While those who regard investment counseling as being of a professional character consider that their activities should be confined to giving specialized advice in individual cases, there are many so-called investment counselors who engage either regularly or incidentally in activities manifestly of a nonprofessional character. Thus, some counselors give investment advice in conjunction with their activities as brokers or dealers in securities. Other investment counselors publish manuals or periodicals. Still others may also be engaged in real estate management or in any number of different occupations. In ordinary usage the title of investment counselor is applied to individuals who may not even profess to be more than intelligent tipsters as well as to individuals of considerable training and experience who render a service of at least a semi-professional nature.

In form of organization, investment counselors range from a small unit with a single proprietor to a large corporation with several hundred employees and administering funds totaling millions of dollars. Thirty investment counsel firms in Illinois responded to a questionnaire sent by the Federal Securities and Exchange Commission, but this is admittedly not a complete enumeration, and the total number is certainly many times as large. Illinois ranked fourth to New York, California, and Massachusetts in the number of investment counsel firms replying to the questionnaire.

(1) STATE OR FEDERAL REGULATION

A basic assumption in adopting regulation of investment counselors as a public policy would be that the business, or profession, is affected with a degree of public interest adequate to justify reasonable regulation under the State's police power. Because of the dangers to the public from fraudulent or misinformed advice, the courts would quite probably uphold reasonable regulations. This point of view is supported by the existence of some type of regulation in several States. The legality of such regulation could not, however, be definitely established in Illinois unless a statute were enacted and its validity ruled upon by the courts. Accordingly, the major question is first the desirability and legality of regulation generally.

Statutes providing for some measure of regulation regarding investment counselors exist in six States. These States are California, Connecticut, Michigan, New Hompshire, Oklahoma, and Rhode Island. In addition, administrative officers in several other States have attempted regulation of investment counselors under general statutory provisions applying to dealers in securities, although these statutes do not specifically mention investment counselors.

The National Government has not enacted any statute for the regulation of investment counselors. However, the Federal Securities and Exchange Commission has been making a study of investment counsel organizations in connection with a general survey of investment trusts and investment companies. The Commission reports that various persons concede that the problem of investment counselors must be dealt with on a national basis in order to be solved.[3]

It appears accordingly that question may arise not only as to the desirability of any regulation of investment counselors but also as to the relative merits of Federal and State regulation. This report is concerned solely with possible regulation of investment counselors by the State government of Illinois. Three bills providing for such regulation were introduced during 1939 in the regular session of the Sixty-first General Assembly, but no legislation on the subject was enacted.[4]

Some limited administrative regulation of investment counselors does exist in Illinois. The rules promulgated by the Secretary of State under the securities law provide that all advice given by investment counselors shall be solely on the basis of advantage to the investor, and without regard to possible profits to the counselor through the sale of securities or through handling transactions for the investor. It is further provided that any counselor who in any manner acts as a dealer in securities or in a related capacity must obtain registration under the law. This registration is required of security dealers, brokers, solicitors, agents, and issuers of securities. Registration is not required of investment counselors who merely give advice as to investments without placing contracts for the purchase or sale of securities. The rule on this subject is as follows:

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[3] Securities and Exchange Commission, Holding Company Act Release No. 1696 (Aug. 23, 1939), p. 7.

[4] The 3 bills are Senate bills 505, 570, and 601.

"Investment counsel or advice, whether by one specializing solely in rendering investment counsel or advice, or by a dealer or broker, incidental to usual transactions in securities, shall be strictly on the basis of fiduciary relationship between the counselor or advisor and the investor or prospective investor. In no event shall such counsel or advice be influenced or colored by the element of profit or compensation through the sale or trade-out of any security held by the investor. Any advice or counsel given to an investor respecting the position of a security held by such investor must be solely on the basis of interest or pecuniary profit to the investor. Any investment counselor who in any manner whatsoever, either directly or indirectly, places or assists in placing any contract for the purchase or sale of securities is held to be a registrant and must be qualified as provided by the provisions of the Illinois securities law." [5]

The administrative officers who enforce the securities law of Illinois inform us that they doubt whether the rule quoted above has had much effect, and that persons denied registration as brokers and dealers may set themselves up in business as investment counselors. Since the securities department can penalize violations of the rule only by revoking or denying registration, there is no way in which the securities department can enforce the rule against those who do not desire registration. It is thought, however, that the existence of the rule may be of some advantage in furnishing State's attorneys with a possible basis for criminal action charging violations of the securities law. In any event, it appears that no effective regulation of investment counselors now exists in Illinois.

The effectiveness of possible self-regulation of investment counselors by means of national, regional, or State associations of those who engage in this type of enterprise should perhaps be considered in connection with proposals for statutory regulation. Without a doubt, much can be done toward promoting high standards of ethics and qualifications by the device of adopting high standards for membership in voluntary associations and by enforcing such standards. At least two associations exist with this as one of their declared purposes.[6]

Self-regulation of investment counselors through voluntary associations would not, however, solve the problem of regulation. The associations that now exist do not have a membership broad enough to exercise effective control over the general body of investment counselors. Furthermore, the type of investment counselor that resembles a tipster, and against whom the public is in the greatest need of protection, is not likely to conform voluntarily to any code of ethics. Accordingly, it may be concluded that if regulation is thought desirable, such regulation must be entrusted to an agency possessing powers of compulsion.

(2) DEFINITION OF INVESTMENT COUNSELOR

A major problem in considering a regulatory statute would be the need and desirability of defining the application of the law. Careful definition is necessary because those who now call themselves investment counselors might avoid the use of that title if by that means they could escape whatever regulation is provided. A definition might also seem desirable in order to make it clear whether the regulatory measure applies only to investment counselors who give specialized advice concerning particular investments or also to the publishers of factual services who supply statistical and analytical information concerning market developments generally.

The several bills in relation to investment counselors introduced in the last session of the general assembly did not seek to regulate as investment counselors purely informative services, although they did cover services which offered predictions as to market developments. The definitions in the bills were similar, the following definition being taken from senate bill 601:

"'Investment counselor' means any person, firm, or corporation who for compensation or any consideration of value gives or purports to give advice with respect to the advantages or disadvantages of investing in any security as defined by the provisions of the Illinois securities law, or who charges or accepts any consideration or provides therefor, for issuing, publishing, distributing, delivering, mailing, or sending any telegram or telephone message or in any

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[5] Secretary of State, Securities Department, "Rules and Regulations With Reference to Dealing in Securities Under the Illinois Securities Law" (effective December 1, 1938), rule 15.

[6] These are the Investment Counsel Association of America (formed during 1937), with headquarters in New York City, and the Investment Counsel Association of Southern California.

manner causes to be issued, published, sent, delivered, or mailed, any circular, letter, publication, or message predicting the future market value or price or recommending the sale or purchase of any corporate stocks, corporate or public bonds or securities, grains, livestock or commodities, or recommends the investment of funds in or refraining from investing funds in any corporate stocks, corporate or public bonds or securities."

This definition, it may be noted, would make any regulation apply only to those who furnish advice for a consideration of value. However, it would be immaterial under the above definition whether the advice relates to stocks and bonds or to grains, livestock, or other commodities. Subject to possible refinements in language the definition quoted above may perhaps be thought satisfactory.

An analysis of the definitions found in the laws of other States gives rise to two questions concerning the definition of investment counselors. In the first place, it may be deemed desirable to make any possible regulations apply only to those who give advice concerning "specific" securities. The insertion of the adjective "specific" would be intended to exclude from regulation those who give only advice of a general economic nature.[7] Whether this is desired, would, of course, be a question of policy. Furthermore, difficulties in administration may arise as to just what constitutes advice concerning specific securities, whether it means advice as to a specific security or also includes advice concerning a class of securities. Accordingly, the use of qualifying adjectives, such as the word "specific," requires careful consideration.

In the second place, it may be thought necessary to define what constitute "securities," advice concerning which makes the action come within the scope of the proposed act. The general practice in those States regulating investment counselors is to incorporate in the act the definition of securities as given in the State blue-sky law. In addition, however, other items may also be included by enumeration. For example, New Hampshire treats as securities contracts of services or advice relating to investments, or memberships in organizations purporting to render such services or advice. Sellers of such contracts or memberships are then subjected to regulation as dealers in securities.[8]

Whether or not to add to the definition of "securities" as found in the State blue-sky law depends upon whether that definition is broad enough to cover all types of investments which it is desired to include in the Investment Counselor Act. In Illinois the blue-sky law does not cover investments relating to grains and livestock, but these are included in the definition quoted above from senate bill 601. The same bill also included a general definition of "securities" as any item, article, or thing with respect to which investment counselors give advice or predict the future value of. Such a general definition may be thought desirable in order to assure the inclusion within the act of all varieties of investments (such as whisky warehouse receipts and cemetery lots) or may, on the other hand, be thought undesirable as possibly productive of confusion if the definition of securities as contained in the blue-sky act is also incorporated by reference.

(3) EXEMPTIONS FROM REGULATION

Regulatory statutes concerning investment counselors appear to exempt from their provisions those who furnish advice without any remuneration or valuable consideration, apparently because it is thought impracticable to regulate such gratuitous services. Newspapers and journals generally also seem to be excluded although this is not explicitly stated in the statutes, the exemption apparently being based on general constitutional and legal principles. In addition various other types of counselors are sometimes excepted. Those excepted in one or more States include brokers, attorneys, banks, savings and loan associations, trust companies, and certified public accountants. The reasons for these exceptions are varied, but the basic reason seems to be that such persons and firms are already subject to governmental regulation of one type or another. Furthermore, the investment advice furnished by these excepted groups would seem to be merely incidental to some other function being performed by them. The desirability of exempting these and other persons or organizations from regulation that is thought feasible for investment counselors generally would, of course, be a question raised in Illinois. Apart from deciding the merits of each claim

[7] For such a definition see Connecticut General Statutes, 1937 supp., ch. 212, sec. 747d.
[8] New Hampshire Public Laws (1926), ch. 284, sec. 2, as amended by Laws of 1929, p. 47.

for exemption, a decision would have to be made as to whether to exempt only those who incidentally and occasionally give advice as to investments or whether to exempt as a general rule all who regularly furnish investment advice if they also belong to one of the groups in relation to which some other form of governmental regulation exists.

Various grounds may be stated in favor of exempting members of particular professions or occupations from any possible regulation as investment counselors. Thus, in the case of attorneys, adequate safeguards for the public may be thought to exist in the lawyer's liability to disbarment in case he engages in unethical practices. Similarly, banks and trust companies regulated by National and State authorities may be thought to be subject to regulation sufficiently extensive, and to adhere to a standard of conduct sufficiently high, to make it inadvisable to impose further regulations. Certified public accountants, examined, and licensed by the State, might claim exemption on that ground. Brokers and security dealers, subject to regulation by the State under the "blue sky" laws, and also by the exchanges with which they deal, may also claim to be already subject to adequate regulation.[9] To these claims for exemption from regulation various answers could be made. For example, in the case of brokers who act as investment counselors it could be said that regulation is desirable to assure that they always act in the interest of their clients, since, as brokers, they are in a position, by advising buying and selling, to make a commission on the transactions, in addition to any fee that may be charged for the investment advice which they render.

The effectiveness with which claims for exemption from general regulations could be prosecuted might seem to depend on the nature of the regulation being considered. It might be thought that if detailed regulations are adopted they should apply to all counselors, while if the regulations are less severe it might be feasible to exempt those who are already subject to equivalent regulation on other accounts. On the other hand, those investment counsel groups that do not claim exemption, or whose claims are rejected, might argue that a spirit of fair play requires that the same regulations apply to all their competitors, whether or not these competitors be also subject to regulation as attorneys, accountants, brokers, or banks.

(4) PUBLISHERS OF INVESTMENT ADVICE

A particular problem in defining the application of a law regulating investment counselors arises from the existence of individuals and firms who furnish investment advice solely by means of publications. Insofar as such individuals and firms also render specialized advice to individual clients, they might be subject to any regulatory measure that may be adopted. The question arises, however, as to whether or not services which give the same general advice to all their clients, by means of some circular or other publication, are actually engaged in a type of investment counseling as to which regulation is feasible.

The reason for considering these generalized investment services in relation to possible regulation, is to be found in the greatly varying types of news, facts, and conjectures that are circulated. Criticism is also prevalent of advertising policies which sometimes involve great overemphasis of the value of the service supplied and of the profits which can be expected from the use of such services. Then, too, question may arise as to the good faith of some of the less reputable of these generalized investment services. The situation with regard to financial publications has been summarized as follows:

"Even the honest and well-intentioned, it is doubtful whether, as a whole, these organs of news do more to inform or misinform their readers when they go beyond reporting and analyzing facts and figures.

"Often, however, they are not honest but are open to suspicion of willingly lending themselves to the use of stock market promoters and manipulators who seek to influence the course of security prices through the use of propaganda. Sometimes a single employee may be corrupted without the knowledge of his superiors. Sometimes the organization itself is corrupt. Sometimes it is the unwitting dupe of clever machinations. The worst forms of tipster sheet exist for no other reason than to lure the investor and gambler to their financial ruin. Brokers' market letters are issued in most instances for the purely selfish purpose of exciting speculative fervor." [10]

[9] For a discussion of such claims, see the "Report of Public Hearing of Investment Counsel Firms before the Securities and Exchange Commission," Investment Counsel Annual (1938), pp. 152–3.

[10] Twentieth Century Fund, Inc., the Security Markets (1935), p. 692.

These investment services which function through publications sent to their subscribers, rather than through individualized advice, would present several difficulties not found in regulating investment counselors generally. In the first place, the large number of agencies publishing investment facts and interpretations is well known, and a very large administrative staff would be required to enforce detailed regulation. Secondly, such information is supplied both by newspapers and by specialized financial journals and services. The accepted rights of freedom of the press and due process of law might prevent any general regulation and perhaps also supervision over particular types of publications, even if the advertisements of these publications occasionally quite exaggerate the value of the factual information which is supplied. That the constitutional guarantee of liberty of the press is applicable to publications of all types, and not only to newspapers, has been clearly indicated by the United States Supreme Court in the following terms:

"The liberty of the press is not confined to newspapers and periodicals. It necessarily embraces pamphlets and leaflets. These indeed have been historical weapons in defense of liberty, as the pamphlets of Thomas Paine and others in our own history abundantly attest. The press, in its historical connotation, comprehends every sort of publication which affords a vehicle of information and opinion.[11]

To the problem of formulating reasonable and practicable regulations for the factual services must, accordingly, be added legal and constitutional difficulties inherent in the attempted regulation of any individual or organization functioning primarily by means of published circulars or volumes. However, liberty of the press is not an absolute right, and some types of regulation may be both constitutional and feasible, assuming that regulation of some sort is thought desirable. Such regulation could probably not legally take the form of licensing publications or prohibiting certain types of publications. Regulation of the publishing of investment advice in order to conform with constitutional requirements, would probably have to be confined to punishing, by civil or criminal penalties, those who perpetrate or attempt to perpetrate frauds or other specific acts declared to be contrary to law.

This seems to be the situation in the States generally and may be the only feasible course of action. It has been suggested, however, that the possibility of fraud or other illegal and unethical practices on the part of publishers of investment facts and advice could be reduced if such publishers were required to file copies of their bulletins and circulars with some State agency. The knowledge that such publications would be a matter of public record, and might serve as a basis for civil or criminal action, could be expected to have a restraining effect upon publishers. However, the requirements of such filing might also be of little effect, particularly if it appears that no effort is made by the administrative authorities to scrutinize the many documents that would be received, and a great deal of administrative effort would be necessary both to enforce the filing of publications and to initiate action founded on statements contained in such publications. Furthermore, the requirement of filing could probably not be enforced against publications issued in other States and sent to residents of Illinois.

It may be thought desirable specifically to exclude from regulation the publishers of generalized investment information, along with those who furnish only economic advice generally. This may be done by carefully defining the term "investment counselor" so as to exclude "any person or organization which engages in the business of furnishing investment analysis, opinion, or advice solely through publications distributed to a list of subscribers and not furnishing specific advice to any client with respect to securities, and also persons or organizations furnishing only economic advice and not advice relating to the purchase or sale of securities."

This possible definition is generally the same as that used by the Federal Securities and Exchange Commission in limiting the scope of its report on investment counsel organizations.

(5) TYPES OF REGULATION

Two general types of regulation exist. Investment counselors may be regulated as brokers or dealers in securities, or they may be subjected to special regulation as investment counselors. In four States (Michigan, New Hampshire, Oklahoma, and Rhode Island) investment counselors are required to

[11] *Lovell* v. *Griffin*, 303 U. S. 444 (1938).

obtain registration under the State securities law as brokers or dealers in securities. Two major reasons are offered in support of this type of regulation. In the first place, it is said that some counselors act as brokers or attempt to sell securities while others have connections with brokers or sellers of securities, so that the functioning of most investment counselors cannot readily be separated from the business of selling securities. Secondly, regulation of investment counselors by requiring registration as dealers or brokers is easier to enforce, since machinery for such regulation already exists and since experience in regulating dealers and brokers has already been acquired.

In two States (California and Connecticut) special provision is made for the regulation of investment counselors. This has the advantage of permitting the regulations to be adapted specifically to the problems that relate to investment counseling. This type of special regulation would be preferred by those investment counselors who are independent of brokers and dealers and who point out that an investment counselor who is also a licensed broker or dealer is in a position to give advice from which he can (by selling securities or handling the transaction) receive benefits in addition to his fee for rendering advice. This might give rise to questions as to whether a counselor who is also a dealer or broker can be relied upon always to give unbiased advice.

Once the type of regulation to be adopted is determined, the related detailed provisions would require consideration. Those who view investment counseling as a profession, look forward to a time when a system of examinations can be adopted as a prerequisite to the practice of investment counseling.[12] It is generally said, however, that a system of examinations is not yet feasible due to the lack of adequate standards and the fact that the "profession" of investment counseling is still in its formative stages.

Existing regulations in the States take the form or requiring registration and the filing of essential facts as to the form of business conducted, the business experience of the principal officers, conviction for crimes on their part, any denials of licenses under the securities law, and similar statements. Periodical financial reports are also sometimes required. In a few cases the required information is more elaborate, and in Connecticut copies must be submited of agreements with clients and of circulars and publications.

The license is usually granted unless certain disqualifications, set forth in the statutes, are discovered. In general, the license is issued if the firm is of good business repute, is apparently qualified to act, if certain laws have not been violated by the firm or its officers, and if fraudulent transactions are not involved. The fee for the license is an annual one, and is usually the same as that charged for a license as a dealer in securities. The license may be subject to revocation for a variety of causes.

Further indications of the type of information required for registration and of the grounds for denying registration may be found in the appendix to this report. In general, the administrative provisions regarding regulation of investment counselors are similar to those for the regulation of brokers and dealers in securities. The provisions for such regulation now in effect in Illinois could readily be adapted to the regulation of investment counselors.[13]

As has been indicated above, various types of regulatory measures could be devised. In the first place, investment counselors may be regulated specifically as such or they may be required to obtain registration as brokers and dealers in securities. In the second place, the regulation may take the form of requiring a system of examinations as a prerequisite to the practice of investment counseling, or there may merely be provided a system of registration much like that now in force for brokers and dealers in securities. Some further attention may be given to the relative merits of a system of qualifying examinations as distinguished from a system of registration based on applications submitted to the administrative agency.

A system of qualifying examinations exists in Illinois with regard to the right to practice various professions, such as law and medicine, and also with regard to the practice of certain semiprofessional occupations, such as plumbing and barbering. In all these cases, standards have been developed on the basis of which it is possible to administer a qualifying examination. The adoption of a system of examinations for investment counselors would require the development of a similar set of standards. Setting such standards would probably not

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[12] *Investment Counsel Annual*, vol. 2 (1939), p. 175.

[13] These provisions may be found in Illinois Revised Statutes, ch. 121½, sec. 118e.

meet with insurmountable difficulties, even though the practice of investment counseling is still in its formative stages and even though the type of training and experience had by different counselors varies greatly.

A system of regulation based upon registration rather than upon examinations would encounter fewer difficulties. The procedure under a system of registration would involve the filing with the administrative agency of much the same type of information as is now required of brokers and dealers under the securities act. This information could include a statement of the financial net worth of the applicant. A minimum net worth of $5,000 is required in Illinois of brokers and dealers in securities and, although it may not be deemed necessary in the case of investment counselors, some such a requirement might be of value in eliminating from practice individuals and firms clearly in the category of irresponsible "fly-by-night" organizations.

Upon the basis of experience in Illinois with the regulation of brokers and dealers, certain conclusions may be drawn regarding the probable operation of a registration requirement for investment counselors. We are told that probably few applications would come from persons unable to present evidence of good business repute or lacking at least some training or experience related to investment counseling. It could, accordingly, be expected that few applications for registration would be denied. The effectiveness of a registration requirement, therefore, results mainly from threats to revoke, or actual revocation, of registration if the registrant engages in practices contrary to the statute or the rules promulgated thereunder. In addition, the records submitted in accordance with the registration requirement may be of value in supporting actions before the courts.

Another aspect of regulation which should be considered relates to possible incidental effects of regulation. The chief arguments for governmental regulation of those who give investment advice arises out of the inability of the average investor to determine for himself the qualifications or integrity of his counselor and the claims that he should therefore receive protection in this respect from some governmental agency. The opponents of governmental regulation point out that a comprehensive regulatory system, even if practicable, might have the effect of unduly restricting competition among investment counselors. They say also that a limited degree of regulation might actually be less desirable than no regulation at all, since limited regulation might give investors a false sense of assurance in dealing with investment counselors registered under the law. This follows from the possibility that, despite the fact that governmental regulation is not intended as a guarantee of the quality of the services offered, there will be some counselors who will point to the fact of their registration as evidence that the services they offer bear at least some mark of approval on the part of the State. Thus governmental regulation may be supported by those investment counselors who look upon superficial regulation as a device for making more readily salable a service concerning which there might otherwise be a great deal of suspicion. These possibilities need not necessarily outweigh the arguments in support of regulation as a preventative of possible fraud and misrepresentation or as an assurance that investment counselors possess at least certain minimum qualifications.

(6) PRACTICES WHICH MAY REQUIRE REGULATION

Sound administration may require that a statute dealing with a new subject of regulation should not attempt to deal specifically with all possible abuses, but should be sufficiently broad to allow for experimentation with the view to amendment of the act as experience is acquired. Accordingly, the enumeration below of certain practices of investment counselors is not meant to imply that each should be the subject of a specific prohibition or regulation. However, these are the practices generally recognized to be the phases of investment counsel activities most subject to abuse.

Solicitation of accounts.—Investment counselors solicit accounts in two ways, by the use of salesmen or through advertisements. In addition, some accounts are obtained without solicitation, the client being referred to the investment counselor by a brokerage firm or other person or group. Special consideration need not be given to the use of agents since, judging by the practice in other States, a regulatory measure applying to investment counselors would also apply to their salesmen. It may be noted, however, that the registration fee charged agents in these States is lower than that charged their principals.

Vigorous solicitation of clients is common on the part of nearly all investment counselors, since they are offering a service with which investors have not long

been familiar. Such solicitation may be by word of mouth, by means of advertisements, or by circulars and pamphlets. The major regulatory problem is one of reducing or eliminating claims which may involve misrepresentation, fraud, or startling promises as to the value of the service offered. Illinois has a statute which may be invoked in cases of fraud or misrepresentation. The provisions of this law are as follows:

"Whoever, with intent to sell, or in any wise dispose of merchandise, securities, service, or anything offered by him, directly or indirectly, * * * causes, directly or indirectly, to be made, published, disseminated, circulated, or placed before the public, in this State, in a newspaper or other publication, or in the form of a book, notice, * * * circular, pamphlet, letter * * *, or in any other way, an advertisement of any sort regarding merchandise, securities, service, or anything so offered to the public, which advertisement contains any assertion, representation or statement of fact which is untrue, misleading or deceptive, shall be guilty of a misdemeanor and on conviction thereof shall be punished by a fine of not less than $10 nor more than $100 or by imprisonment in the county jail not exceeding 20 days, or by both said fine and imprisonment." [14]

This statute, at least on its face, seems to cover cases where untrue, misleading or deceptive claims are made as to the value of any service offered investors. However, the efficacy of such a law depends, of course, upon the vigor with which it is enforced and upon its construction and application by the courts. Mere exaggerated claims will probably not often be prosecuted. Furthermore, many of the factual services originate in other States, so that punishment in Illinois is generally impracticable if not impossible. Finally, the statute is undoubtedly more readily enforced against those who offer some physical service than against those whose services are of an informative character.

If the statute quoted above is not deemed to guard adequately against possible fraud and misrepresentation in soliciting clients, a statute could be adopted which specifically relates to such action on the part of investment counselors. It might also be possible to provide administrative, rather than criminal remedies. In connection with a general regulatory statute, counselors might be required to deposit with some administrative officer copies of all advertising which they issue. The law might then provide that fraud or gross misrepresentation constitute grounds for revoking the grant of permission to function as investment counselor.

Contingent fees.—The larger investment counsel firms usually establish a scale of fees stated as a percentage of the value of the investment portfolio of their client. Inventories of the value of the portfolio are made at regular intervals, perhaps quarterly, and the fees are stated as a percentage of the value indicated in the inventory, although a certain minimum charge is usually specified. Under this procedure, the fees charged by the investment counselor are somewhat affected by profits made from his advice, since such profits result in increasing the value of the investments held. Likewise, losses from following the advice of counselors result in declines in the value of the portfolio, and a consequent decline in the charges for future services. Various other methods of charging for services are also in use, including a flat annual fee or a specific charge for each report made.

One method of charging for services rendered is generally criticized. This is a fee on a contingent or profit-sharing basis, where the agreement is that no charge will be made unless a profit is made from the advice. The fee charged if such a profit accrues is a stated percentage of the profit. Contingent fees may operate to induce counselors to urge their clients to speculate, since the investment counselor will earn a substantial fee if profits result from his advice, while he will suffer no cash loss if profits are not made.

The charging of contingent fees may also permit certain fraudulent practices. For example, it is said that some individuals advise one client to sell a certain security and advise another client to buy the same security.[15] In the normal course of the market, one client will profit from the advice, either by selling at a higher price than was paid for the security or by buying a security which subsequently rises in value. The adviser of such action, accordingly, is reasonably assured of profiting from his advice given on a profit-sharing basis, although the advice may have been rendered without any analysis of market conditions. The clients of such a "counselor" are being used as pawns.

None of the States definitely forbids the charging of contingent fees. This may be thought to indicate that advice to speculate and fraudulent practices are not to

[14] Illinois Revised Statutes, ch. 38, sec. 249a.
[15] S. F. Porter, New Bait for Suckers, American Magazine (July 1939), p. 14.

be attributed to the fee system. On the other hand, it may be that regulation of investment counselors has not yet developed to the point where the regulation of particular practices can be embodied in statutes. The code of the Investment Counsel Association of America forbids members of the association from charging contingent fees, paragraph IV providing that the:

"Compensation of an investment counsel firm should consist exclusively of direct charges to clients for services rendered, and should not be contingent upon profits, upon the number or value of transactions executed, nor upon the maintenance of any minimum income."

It thus appears that at least the larger and most firmly established investment counsel organizations agree that a contingent fee system is undesirable. However, smaller or newly organized firms would probably argue that, because of the general lack of understanding as to the value of the services which they offer, effective soliciting of clients requires that they be able to sell their services with the agreement that no charge will be made unless profits or a guaranteed minimum income result from the advice furnished. Furthermore, it may be noted that the contingent fee system is said to be a practicable and profitable means of charging for investment advice rendered to small accounts, which accounts the larger investment counsel firms do not accept.[16]

The problem with regard to contingent fees may, therefore, be summarized as follows: A prohibition of such fees would be based upon a desire to discourage investment counselors from giving clients advice to speculate and to prevent counselors from engaging in certain fraudulent practices, such as giving contrary advice to two different clients. However, the adoption of a complete prohibition of contingent fees may hamper small or new counseling firms in acquiring clients. Likewise, the prohibition of contingent fees would require that some other means be devised by which the small investor could avail himself of investment advice, perhaps by more general use of a flat charge for each report made.

Advisory and discretionary accounts.—With regard to the power of the investment counselor to act in relation to the client's investments, two different types of accounts exist: Advisory accounts and discretionary accounts. The former, advisory accounts, seem to be the most common. So far as such accounts are concerned, the investment counselor gives advice as to changes in investments which he deems desirable, and he may urge that this advice be followed as promptly as possible. However, the decision as to whether action should be taken is made by the client.

Insofar as so-called discretionary accounts are concerned, the powers of the counselor are greater. He not only reaches a decision as to what securities should be bought or sold, but he also takes such action in the name of his client. Authority to do so, where it exists, is usually granted by a power of attorney.

In support of the practice of accepting discretionary accounts, various arguments may be stated. The existence of power to act makes it possible for the client to obtain immediate advantage of the advice prepared for him without delays incident to communications between the counselor and his client. Furthermore, a client may be ill, traveling, or in an inaccessible place, so that he cannot take prompt action.

Obviously, a client will not authorize a discretionary account unless he has confidence in his counselor. Some firms strongly recommend discretionary accounts, thinking them efficient, while other firms will not accept discretionary accounts, apparently being unwilling to assume the responsibilities entailed thereby.[17]

From the point of view of the public interest, discretionary accounts are significant only in that they may be used to permit fraudulent practices. For example, a counselor who has several discretionary accounts may have some connection with the brokerage house which executes his orders. He may purchase stocks through this broker. If the stocks rise rapidly immediately afterwards, he may have the purchase credited to his own account, and subsequently sell at a higher price. If the stocks decline in value, or rise only slowly, the order will be entered in the name of some client.[18] Even if the counselor has no connections with a brokerage firm, he may engage in practices which would operate to his own advantage rather than to the advantage of his clients. For example, the counselor may himself own a block of securities. If he desires the price to rise, he could place large orders in the name

[16] Twentieth Century Fund, Inc., The Security Markets (1935), pp. 653–654.
[17] Report of public hearing of investment counsel firms before the S. E. C. in Washington, Investment Counsel Annual, vol. 1 (July 1938), p. 116.
[18] S. F. Porter, cited above.

of his clients for the purchase of the same securities. Or, if he desires the price to fall, and his clients own large amounts of such securities, he may place orders of sale in their behalf. If these transactions are large enough, they may have an appreciable effect on the market value of the securities.

These practices are not now subject to specific statutory regulation. However, laws against fraudulent practices generally may be thought to provide adequate safeguards. Furthermore, the advantages of discretionary accounts may be thought to outweigh possible danger of fraud.

If regulation of discretionary accounts is thought desirable, several types of regulation might be effective. Apart from the possibility of forbidding discretionary accounts altogether, the privilege of accepting such accounts may be limited to cases where the client is traveling, is on vacation, or is incapacitated. Some of the fraudulent practices might perhaps be avoided by forbidding counselors from engaging in speculative practices in their own accounts or from having financial connections with brokers or with dealers in securities. In each case, however, the apparent desirability of the regulation would have to be measured against the disturbing effect the regulation would have upon the functioning of reputable counselors.

Affiliations with brokers and dealers in securities.—Another aspect of the functioning of investment counselors which may require consideration is the relation of such counselors to individuals and firms who market securities or who handle transactions in securities. Many counselors have some connection, direct or indirect, with such individuals and firms, although such connections are not universal. Furthermore, brokers and dealers in securities frequently maintain an investment-counsel service in connection with their other activities. Fifty-three of the three hundred and ninety-four investment-counsel firms that replied to a questionnaire of the Federal Securities and Exchange Commission stated that they also acted as brokers and dealers in securities, or were affiliated with an organization acting in that capacity.[19]

That affiliation between an investment counselor and a broker or dealer in securities is not inherently bad may be thought demonstrated by the fact that several States do not regulate counselors as such, but instead effect regulation by requiring counselors to be registered as brokers or as dealers in securities.

The criticisms of counselors also acting as brokers or dealers are founded upon possible encouragement of practices bordering on fraud. The major danger is that a counselor connected with a brokerage house will unduly urge frequent buying and selling of securities, even when the wisest procedure might be for the client to retain existing investments. By stimulating transactions, the counselor connected with a brokerage house will increase the profits of the organization, since the fees charged are based on the volume of transactions, and some share of the profits may be paid to the counselor.

A counselor who is also engaged in the business of selling securities is in a position to buy securities and then recommend their purchase by his clients at a higher price. A possible safeguard against fraud or deception in such sales is the requirement that the client be informed that the investment counsel owns the securities offered for sale.

In Illinois, an investment adviser who sells or assists in the sale of securities must be registered as a dealer or broker and is subject to the following rule laid down by the securities department of the office of the Secretary of State:

"If a dealer or broker is also an underwriter or owner of securities being sold or offered for sale, the customer shall be specifically informed of that fact and also as to the fact that the dealer or broker is expecting to realize some other remuneration or profit in addition to the compensation for his services as dealer or broker." [20]

This may be thought to constitute adequate regulation on that point. It may, however, be suggested that a further provision be adopted requiring the customer to be furnished with a statement of the price at which the security was obtained by the seller. This would be intended to prevent the statement regard-

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[19] Securities and Exchange Commission, Report on Investment Counsel, Investment Management, Investmen Supervisory, and Investment Advisory Services (August 17, 1939), p. 14.

[20] Rules and Regulations With Reference to Dealing in Securities Under the Illinois Securities Law (effective December 1, 1938), rule 11.

ing the ownership of the security by the counselor from being made in such a way as merely to give the impression that such ownership is an indication that the security is a sound investment. The desirability of such an additional statement would depend upon whether the information would be of value to the client in deciding whether the advice to buy was given in good faith. Separation of counseling functions from brokerage and selling activities has not been attempted in any State.

Custody of funds and investments.—It appears that most investment counsel firms refuse to acept the actual custody of their clients' funds and investments. This refusal is apparently based upon an unwillingness to assume the responsibilities which such custody involves. The acceptance of the custody of funds and investments, moreover, opens the possibility of activities which may be both unethical and fraudulent. For example, if the investment counselor has custody of his clients' investments he may use them as security for personal loans. Accordingly, it may be desirable to give consideration to a possible prohibition against counselors assuming custody of funds and investments. This may, however, not be practicable, since some counselors, particularly those who also act as brokers, may find the custody of funds and investments to be necessary to efficient functioning, particularly in the case of discretionary accounts.

(7) SUMMARY

The arguments for and against statutory regulation of investment counselors are referred to in this report, but are not given extended analysis. Accordingly, this treatment of possible regulation is merely a discussion of items that might be thought to require consideration if regulation is deemed desirable and feasible.

If regulation is deemed desirable, it could be effected either by regulating investment counselors as a special group or by requiring counselors to subject themselves to regulation as brokers and dealers in securities. If it is thought more feasible to follow the latter course of action, the regulations governing brokers and dealers could be made to apply to investment counselors.

If, however, investment counselors are to be regulated as a separate group, problems would arise as to the precise type of regulation to be enforced. It would be possible to adopt a registration procedure, under which an investment counselor could not practice until his application for registration had been approved by some State agency. Even if specific registration as an investment counselor is required, such a plan would probably not be greatly different from that now enforced as to brokers and dealers in securities.

The other alternative is to provide a more comprehensive regulatory system, including a system of qualifying examinations which the applicant must pass before he could engage in investment counseling. The following quotation illustrates the type of special regulation which could perhaps be developed in relation to investment counselors:

"1. No individual should be permitted by the several States to practice as an investment counsel without a degree of certified investment counsel, and a license to be awarded after proper examination by suitable State authorities.

"2. No individual should be granted, or permitted to retain, a license to practice as an investment counsel for pay who is in the business of underwriting, distributing, buying, or selling securities either as a broker or principal; or who is in the employ of, or is in any way affiliated with, or is a stockholder or partner in, any organization engaged in any manner whatever in such activities.

"3. No licensed investment counsel should be permitted to employ, or to retain in his employment, any one in any way connected with any activity named or implied in paragraph 2, above; or to associate himself as a partner, joint stockholder, or otherwise with any such disqualified person.[21]

These constitute recommendations for legislation made by a security markets survey staff of the Twentieth Century Fund, a research organization of national scope. These suggestions, however, were not made with particular reference to the State of Illinois, and have not been adopted in any State. Furthermore, such comprehensive regulation, even if conceded to be ultimately desirable, may not be considered feasible as a first step in regulation even by those who feel that some regulatory measure is desirable.

In the case of so-called investment counselors who function only by means of publications, a special problem would arise with regard to possible regulation.

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[21] Twentieth Century Fund, Inc., Stock Market Control (1934), p. 203.

It would be necessary to develop a type of regulation which would not violate accepted principles of freedom of the press.

Only a few States now provide for the regulation of investment counselors. Furthermore, the experience of these States is of limited value as a guide to Illinois in devising means of regulation. This is due to the short time during which such legislation has been in effect, and to the general absence even in most of these States of attempts at comprehensive regulation.

Appendix

Statutes relating to investment counselors [1]

State (and citation)	Do statutes specifically provide for regulation?	Nature of regulation (or comment)
Alabama	No	
Arizona	No	
Arkansas	No	
California (Gen. Laws (1931), Act 3814, sec. 9.)	Yes	Every person or firm, other than a broker [or attorney] acting as an investment counsel must secure a State certificate. Application must give facts showing good business repute of principal officers and agents and show they possess experience and education qualifying them to act; also the general plan of conducting business. Certificates issued if of good business repute and qualified, if they have not violated certain laws, and are not about to engage in fraudulent transactions. License may be suspended or revoked.
Colorado	No	
Connecticut (1937 Supp. to Gen. Stat., ch. 212, sec. 747d).	Yes	Extensive statutory provisions. Require those who engage in business of advising others concerning investments to register, whether advice is given directly, by mail, or through publications, if advice relates to specific securities and is given for a consideration. Excepted from regulation are banks, savings and loan associations, trust companies, and persons registered in State as "brokers." Information is required concerning form of organization, principal officers, their business record and experience, nature and method of conducting business, any convictions of criminal offenses, and any past denials or suspensions of licenses relating to securities. Licenses may not be issued within 5 years after conviction of a criminal offense, etc., and may be refused if reason to believe necessary in order to protect public against fraud. Licenses may be withdrawn for false statements in registration, dishonesty, giving fraudulent advice, etc. Annual registration fees of $50 and $3 for agent, plus costs of any investigation. (NOTE.—Investment counselors and their agents appear to be subject to same type of regulation as are brokers and their agents; same forms are used and same fees charged. In addition detailed information regarding nature of business is required, including copies of all agreements with clients and copies of recent circulars or publications. Act applies only to counselors acting within or from State.)
Delaware	No	
Florida	No	
Georgia	No	
Idaho	No	
Illinois	No	
Indiana	No	
Iowa (letter from State valuation counsel).	No	But if counselors attempt to sell or dispose of securities, there is a disposition by administrative authorities to attempt regulation as a dealer or salesman of securities.
Kansas	No	
Kentucky	No	
Louisiana	No	
Maine	No	
Maryland	No	
Massachusetts (letter from director of State securities division).	No	But some discussion of regulation in State and some effort by administrative officers to regulate counselors as brokers.
Michigan (Public acts of 1935, No. 37, p. 58 (sec. 9789 of Comp. Laws); letter from one member of corporation and securities commission).	Yes	Any person who for a consideration acts as a counselor and advises the purchase or sale of securities must first obtain registration as a dealer in securities (fee of $100 annually). (NOTE.—One of the commissioners in charge of regulation writes that he favors licensing and examination of counselors as such, and not as dealers.)
Minnesota (letter from State commissioner of securities).	No	But the securities division, at the last session of the legislature, attempted to have a law passed giving division same regulatory powers with resepct to investment counselors as exist concerning brokers and security dealers.

[1] Data obtained through a search of the statutes and by means of questionnaires.

Statutes relating to investment counselors—Continued

State (and citation)	Do statutes specifically provide for regulation?	Nature of regulation or comment)
Mississippi	No	
Missouri (letter from commissioner of securities).	No	But State securities division has taken the position that investment counselors should register as dealers in securities, since in advising clients they are believed to act in some manner within the scope of the statutory definition of dealer. It is not known whether the courts would sustain this position.
Montana	No	
Nebraska	No	
Nevada	No	
New Hampshire (Public Laws, ch. 284, sec. 2; also letter from State insurance examiner.	Yes	Law treats sellers of contracts of services or advice relating to investments, or sellers of memberships in organizations purporting to render such services or advice, as dealers in securities. Must be licensed as dealer whether services are offered by letter, circular or advertising (annual license of $25 for counselor and $10 for agents). Application held 4 weeks for investigation, and issued only if person or firm deemed of good repute, financial standing, reliability and possessed of right to public confidence. Various data may be required, including copies of circulars or advertisements. State may disapprove in advance any advertising, offering or selling if they do not disclose pertinent facts or if there is serious financial danger to purchaser. License may be revoked for dishonest, deceitful or fraudulent conduct. Banks and trust companies are excepted from act.
New Jersey	No	
New Mexico	No	
New York	No	
North Carolina	No	
North Dakota	No	
Ohio	No	
Oklahoma (Okla. Stat. (1931), sec. 4907 as amended by laws of 1933, p. 265; also letter from assistant bank examiner).	Yes	Investment counselors must be registered as dealers in securities and are subject to same regulations (fee of $25 for principal and $5 for salesmen, but maximum of $500 for any firm). Applies whether advice is given directly or by publications or writings. License issued if of good repute. Bond of $5,000 required. Law excepts attorneys who perform such services in connection with practice of law and certified public accountants who make analyses or issue reports concerning securities.
Oregon	No	
Pennsylvania	No	
Rhode Island (Gen. Laws) (1928), ch. 121, sec. 1; also letter from securities commissioner.	Yes	Registration as broker (agents as salesmen) is required of every person who, for any consideration, acts as an investment counselor and advises the purchase and sale of securities (annual fee of $25 for broker and $2 for salesmen). Must be of good character. (NOTE.—Effect is requirement of periodic financial statements to determine standing and responsibility.)
South Carolina	No	
South Dakota	No	
Tennessee	No	
Texas (letter from securities commissioner).	No	State securities commissioner writes that opinion of his department is that some regulation is needed to prevent counselors from also acting as dealers in securities in order to assure unbiased advice.
Utah	No	
Vermont	No	
Virginia	No	
Washington	No	
West Virginia	No	
Wisconsin	No	
Wyoming	No	

Mr. SCHENKER. Senator, we promised that we would submit a memorandum on the constitutionality of section 18 (d) of the investment company bill. We should like to submit that memorandum at the present time. We may want to supplement it.

Senator HUGHES (presiding). Very well; it will be admitted.

(Memorandum entitled "Constitutionality of Section 18 (d) of the Investment Company Bill" is as follows:)

MEMORANDUM

APRIL 25, 1940.

To: The Securities and Exchange Commission.
From: The General Counsel.
Re: Constitutionality of section 18 (d) of the investment company bill.

"After 2 years from the effective date of this title, the Commission shall, upon application by the holder of any outstanding security of a registered management investment company, and may upon its own motion, require by order that such company, and every other registered investment company in the same investment company system, take such steps as are necessary or appropriate to effect an equitable redistribution of voting rights and privileges among the holders of the outstanding securities of such company or companies" (Section 18 (d)).

The power of Congress to achieve this end by the means employed is clear.

I

The provision is within the power of Congress to regulate interstate commerce.

The investment industry in almost every phase of its activities uses the mails and interstate commerce. The form of organization and the nature of the business of an investment company is such that it cannot help being engaged in interstate commerce. National securities exchanges, over-the-counter markets, and the mails are employed in accumulating trading in and disposal of portfolio securities and in the distribution of securities of the investment company itself. Investors scattered over the face of the country purchase these securities and are affected by fluctuations in their value. The investment practices of such companies direct the flow of capital supply to industries engaged in interstate commerce, over interstate channels; and by their accumulations of portfolios investment companies may dominate the policies of interstate businesses. The industry is well within the scope of the power of Congress to regulate by the exercise of its plenary control over interstate commerce (*South Carolina* v. *Georgia*, 93 U. S. 410). And, in the exercise of that power Congress may implement, by any reasonable regulatory device, its policy to protect the welfare of the public (*Hamilton* v. *Kentucky Distilleries and Warehouse Co.*, 251 U. S. 146, 156, and investors, *Electric Bond and Share Co.* v. *S. E. C.*, 303 U. S. 419). Congress has already exercised its power to procure an equitable redistribution of voting power in an industry subject to its plenary control over interstate commerce (section 11 (b) (2) Public Utility Holding Company Act of 1935).

The activities of investment companies have a direct and profound effect on interstate commerce; and the manipulations of insiders in investment companies which result in loss to investors are, at the same time, a direct and heavy burden on commerce. They result in a toll upon the flow of capital from savings into industry. Congress may remove this burden by removing the insulation which surrounds insiders. No more direct and reasonable device for this purpose can be provided for, than the device of ordering, where necessary, equitable redistribution of voting control.

The inequitable distribution of voting rights tends to spread loss and harm among investors and to industry. Such being its tendency it is subject to regulation by Congress, under its power to regulate interstate commerce (*Brooks* v. *U. S.*, 267 U. S. 432). Although the inequitable distribution of voting rights may not in itself involve interstate commerce, if, as is the case, the maintenance of such inequitable distribution affects, or burdens interstate commerce, Congress has undoubted power to order a redistribution (*Northern Securities Co.* v. *United States*, 193 U. S. 197; *Minnesota Rate Cases*, 230 U. S. 352; *United States* v. *Ferger*, 250 U. S. 199; *New York* v. *United States*, 267 U. S. 591; *Colorado* v. *United States*, 292 U. S. 522; *N. L. R. B.* v. *Jones & Laughlin Steel Corp.*, 301 U. S. 1; *Santa Cruz Fruit Packing Co.* v. *N. L. R. B.*, 82 L. Ed. 653).

There is no doubt that Congress, by virtue of its power to regulate interstate commerce, could require the compulsory incorporation under Federal law of companies desiring to engage in that commerce.[1] In fact Congress has, in

[1] Watkins, "Federal Incorporation" (17 Mich. L. R. 64, 145, 238); Morawetz, "The Power of Congress to Enact Federal Incorporation Laws and to Regulate Corporations" (26 Harv. L. R. 667); Kellogg, "Federal Incorporations and Control" (20 Yale L. J. 177); Wickersham, "State Control of Foreign Corporations" (19 Yale L. J. 1). The proposals for Federal incorporations and businesses engaged in interstate commerce have been very frequent. For an excellent historical revue of the proposal, see Department of Justice file 146108–163.

the exercise of its fiscal power, and in the exercise of its power to regulate interstate commerce, employed the device of Federal incorporation (*McCulloch* v. *Maryland*, 4 Wheat. 315; *Pacific R. R. Removal cases*, 115 U. S. 1).

In a Federal incorporation law Congress might prescribe the various incidents of voting privileges to be attached to the various classes of shares. In such legislation it might specially provide that all stockholders shall have equal or proportionate voting rights.[2] Congress may, in the exercise of its lesser power, without resorting to Federal incorporation, condition the use of the mails or the channels of interstate commerce with requirements addressed to removing burdens from, and fostering that commerce, by requiring an equitable redistribution of voting power (*Tagg Brothers & Morehead* v. *United States*, 280 U. S. 420; *Stafford* v. *Wallace*, 288 U. S. 496; *Chicago Board of Trade* v. *Olsen*, 262 U. S. 1; *United States* v. *Joint Traffic Association*, 171 U. S. 505).

The doctrine is clear that in the exercise of this power activities may be regulated which do not, of themselves, involve interstate commerce (*Houston, E. & W. T. R. Co.* v. *United States* (Shreveport case), 234 U. S. 342; *Bedford Cut Stone Co.* v. *Stonecutter's Association*, 274 U. S. 37).

II

The requirement that registered companies take steps to redistribute equitably voting rights does not violate the "due process" clause of the Fifth Amendment.

Congress, in its regulation of the affairs of businesses engaged in, and affecting interstate commerce, may penetrate deeply into their affairs and arrangements and make profound changes therein. As set forth, the provision relates merely to the redistribution of voting power. It does not affect the extent of the shareholder's claim on corporate assets. Yet Congress has the power, in effecting a valid purpose, to order a complete redistribution of the material rights of corporate securities, or to order a complete cessation in the conduct of a business.[3] In *Radio Commission* v. *Nelson Bros. Co.* (289 U. S. 266), the Supreme Court held that Congress may delegate authority to delete radio stations as part of a scheme of Federal control over the communications industry. The court said:

"This broad authority (to grant or revoke licenses) plainly extended to the deletion of existing stations if that course was found to be necessary to produce an equitable result * * * that the Congress had the power to give this authority to delete stations, in view of the limited radio facilities available and the confusion that would result in interferences is not open to question. *Those who operated broadcasting stations had no right superior to the exercise of this power of regulation. They necessarily made their investments and their contracts in the light of, and subject to, this paramount authority. This court has had frequent occasion to observe that the power of Congress in the regulation of interstate commerce is not fettered by the necessity of maintaining existing arrangements which would conflict with the execution of its policy * * *.*" [Citing cases.]

In the exercise of its power over interstate commerce Congress may require, under the antitrust laws the dissolution of State-formed corporations, and may prevent the voting of securities when held contrary to an expressed legislative policy without violating "due process" (*Northern Securities Co.* v. *U. S.*, 193 U. S. 197; *U. S.* v. *Standard Oil Co.*, 221 U. S. 1; *U. S.* v. *American Tobacco Co.*, 221 U. S. 106; *U. S.* v. *Union Pacific R. Co.*, 226 U. S. 61; *Continental Insurance Co.* v. *U. S.*, 259 U. S. 156).

Voting rights in corporations are not "vested rights."[4] Although the granting of equal voting rights to all outstanding security holders will deprive the holders of "insiders" shares of their exclusive control, no "vested right" will be taken away. The centralization of control in small minorities has been used

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[2] Proposals for the mere licensing of corporations desiring to engage in interstate commerce have made provisions for equal voting rights. See, for example, the Borah-O'Mahoney Federal licensing bill introduced into the Senate of the United States in the 76th Cong., 1st sess. (S. 330), sec. 5g.

[3] See *Continental Insurance Co.* v. *U. S.* (259 U. S. 156), where a decree to enforce compliance with the Sherman and Hepburn Acts compelled bond holders to exchange obligations constituting claims against one large group of assets for separate claims against individual parts of such assets. The court said: *"The power of the court under the Sherman antitrust law to disregard the letter and legal effect of the bonds and general mortgage under the circumstances of this case in order to achieve the purpose of the law we cannot question."*

[4] *Morris* v. *American Public Utilities Co.* (14 Del. ch. 136, 122 Atl. 696). See also *In re Sharood Shoe Corporation* (192 F. 945).

for the purpose of manipulation and overreaching. No one has a "vested right" in the perpetration of a scheme of distribution of voting privileges which permits such practices, and the deprivation of such a "right" is not subject to attack.[5]

If Congress finds that the inequitable distribution of voting privileges is an evil requiring correction, its findings will not be disturbed (*Norman* v. *Baltimore and Ohio R. R.*, 294 U. S. 240, 311). If the regulations enacted are reasonably addressed to the correction of the evils, they will not violate the "due process" clause of the fifth amendment.

"The fifth amendment in the field of Federal activity, and the fourteenth as respects State action, do not prevent governmental regulation for the public welfare. They merely condition the exertion of the admitted power, by securing that the end shall be accomplished by methods consistent with due process, and *the guarantee of due process as has often been held demands only that the law shall not be unreasonable, arbitrary, or capricious and that the means selected shall have a real and substantial relation to the object sought to be attained*" (*Nebbia* v. *New York*, 291 U. S. 502, 525).

There can be no more reasonable provision for the correction of inequities in the distribution of voting power than a requirement that a redistribution shall take place.

United States v. *Lowden* (Supreme Court, October 1939) reaffirms the doctrine (questioned in *Railroad Retirement Board* v. *Alton Railroad Co.*, 295 U. S. 330) that Congress has broad discretion, as against the claim that "due process" has been violated, to determine whether particular types of regulation will promote the efficiency of businesses in interstate commerce.

The Court in that case, in upholding a condition, fixed by the I. C. C. to its grant of authority to a railroad to acquire lease control of another road, that the acquiring road provide for those employees who would lose their jobs, status, or homes as a result of the merger, said:

"It is said that the statute, as we have construed it, is unconstitutional because not within congressional power to regulate interstate commerce, and is a denial of due process. It is true that in *Railroad Retirement Board* v. *Alton Railroad Co.* (295 U. S. 330), in declaring the Railroad Retirement Act of June 27, 1934 (48 Stat. 1283), not to be a valid regulation of interstate commerce, it was said, among other reasons advanced to support that conclusion, that a compulsory retirement system for railroad employees can have no relation to the promotion of efficiency, economy, or safety of railroad operation. But notwithstanding what was said there, and *even if we were doubtful whether the particular provisions made here for the protection of employees could have the effect which we have indicated upon railroad consolidation, and upon the adequacy and efficiency of the railroad transportation system, we could not say that the congressional judgment that those conditions have a relation to the public interest as defined by the statute is without rational basis.*" [Italics added.]

It is impossible to contend that "the congressional judgment" that there is need for an equitable redistribution of voting rights in investment companies, to insure against the immunized and insulated depredations of insiders, and to free the securities markets, nation-scattered investors and industry of the burden of losses caused thereby is "without rational basis."

III

The provision requiring the equitable distribution of voting rights upon order of the Commission does not constitute an unconstitutional delegation of legislative power.

Any doubt as to the validity of the procision as an "unconstitutional delegation of legislative power" to the Commission must stem from a doubt that the phrase "equitable distribution of voting rights" poses a sufficient standard for administrative action (*Hampton, Jr. & Co.* v. *United States*, 276 U. S. 394). The meaning of invalid delegation has been distilled into the proposition.

"That Congress must first promulgate the primary policy is * * * what the court has meant when denying the right to delegate powers which are 'strictly' legislative * * *" (Comment, 31 Mich. L. R. 786, 789).

[5] Cf. cases arising under the "due process" clause of the fourteenth amendment which permit the States to exercise the equivalent power to discontinue the conduct of pernicious activities (New York ex rel. *Lieberman* v. *Van de Carr*, 199 U. S. 552).

The contention that administrative whim is given rein under the expressed standard is not well founded. If it is true, then reorganization courts have been exercising judicial tyranny for generations, and section 221 of the National Bankruptcy Act, as amended, vests in the courts the power to exercise that tyranny. Corporate history has forged a series of standards which must inevitably govern determinations under this section. These are clear, and well understood, and from them the concept of "equitable distribution of voting rights" gains weight and meaning.

The court has recognized vast powers in Congress to vest quasi-legislative and quasi-judicial functions in nonlegislative and nonjudicial agencies. The capacity of administrative bodies vested with rule-making and adjudicative powers to cope with the increasingly complex problems of our economy has been made possible by the exercise of these powers. Standards set to govern administrative action as broad as "just" suspensions of free importation (*Field* v. *Clark*, 143 U. S. 649, as broad as "public interest"; *New York Central Securities Co.* v. *U. S.*, 287 U. S. 12; *U. S.* v. *Lowden* (U. S. Supreme Court, October term, 1939); "as public convenience, interest or necessity required," *Radio Commission v. Nelson Bros.*, 289 U. S. 266; "reasonable rates," "discrimination," "convenience and necessity," *Intermountain Rate Cases*, 234 U. S. 476, 486; *Railroad Commission* v. *So. Pac. Co.*, 264 U. S. 331, 343, 344; *Avent* v. *U. S.*, 266 U. S. 127, 130; *Colorado* v. *U. S.*, 271 U. S. 153, 163; *C. & O. Ry. Co.* v. *U. S.*, 283 U. S. 35, 42), have been upheld.)

An administrative agency is frequently given power to determine within the terms of more or less specific standards, whether individual action, in individual cases meets those standards. See *New York Central Securities Co.* v. *U. S.* (287 U. S. 12), where the court, sustaining an order of the Interstate Commerce Commission, authorizing the New York Central Railroad to acquire lease control of certain roads, expressly recognized that "* * * the question whether the acquisition of control * * * will aid in * * * securing more efficient transportation service is thus committed to the judgment of the administrative agency upon the facts developed in the particular case." Thus the court will recognize the propriety of the congressional judgment that the Commission proceed to enforce the provision by order in the individual case, adapting its requirements as the individual case requires.

The "hot oil" cases (*Panama Refining Co.* v. *Ryan* 293 U. S. 388), and the N. R. A. case (*Schechter Poultry Corp.* v. *United States*, 295 U. S. 495), are not authority against the provision in question since it cannot be said that the power to determine when a distribution of voting rights is equitable is the power to make an "arbitrary prescription" of legislation. The holding in these cases must also be read in terms of later decisions. (See *N. L. R. B.* v. *Fainblatt*, 306 U. S. 601; *Consolidated Edison Co.* v. *N. L. R. B.*, 305 U. S. 188.)

The judicial history of the delegation concept has been one of liberality. The court has been willing to read standards into delegative legislation where none has been expressly set out. In a consideration of section 4 of the "Act to Regulate Commerce" (24 Stat. 380, c. 104) which permitted the Interstate Commerce Commission to impose higher rates for the short than the long haul, and in which no standards were stated, the court, in preserving the delegation, implied that rates were to be keyed to permit the roads to meet competition (*Intermountain Rate Cases*, 234 U. S. 47).

The evils at which this bill is aimed have been carefully studied and set forth by the Commission. The Commission's reports and the hearings before the committee are matters of public record. In this framework the standard of "equitable distribution" of voting privileges has a distinct meaning and perspective. The court will read the standard in its setting.

"In *New York Central Securities Co.* v. *C. C. C. & St. L. Ry. Co.* (287 U. S. 12), we pointed out that the phrase 'public interest' in this section does not refer generally to matters of public concern apart from the public interest in the maintenance of an adequate rail transportation system; that it is used in a more restricted sense defined by reference to the purpose of the Transportation Act of 1920, of which the section is a part and which, as had been recognized in earlier opinions of this court, sought through the exercise of the new authority given to the Commission to secure a more adequate and efficient transportation system." See *New England Divisions case* (261 U. S. 184); *Dayton-Goose Creek Ry.* v. *United States* (263 U. S. 456); *Texas & Pacific Ry. Co.* v. *Gulf, Colorado & Santa Fe Ry. Co.* (270 U. S. 266, 267). "*Thus restricted, the term 'public interest' as used in the statute, is not a mere general reference to public welfare, but as shown by the context and purpose of the act,*

has direct relation to adequacy of transportation service, to its essential conditions of economy and efficiency, and to appropriate provision and best use of transportation facilities." *Texas* v. *United States* (292 U. S. 522, 531). (Italics added.) *U. S.* v. *Lowden* (U. S. Supreme Court, October term, 1939).

Mr. SCHENKER. We also have a short memorandum, which we may want to supplement, on the constitutionality of the regulation of investment advisers.

Senator HUGHES (presiding). Very well; that will be admitted.

(Memorandum entitled "Federal power to regulate investment advisers" is as follows:)

MEMORANDUM

To: The Securities and Exchange Commission.
From: The General Counsel.
Re Federal power to regulate investment advisers (S. 3580, title II).

Title II of the bill is addressed to the regulation of investment advisers.

An investment adviser is defined as a person who, "for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investment in, purchasing, or selling securities." Persons who, as part of a regular business, issue securities analyses or reports are included. The definition expressly excludes banks, lawyers, accountants, or engineers who perform such services merely as an incident to the practice of their professions. Publishers of bona fide newspapers or magazines are also excluded from the definition. The Commission may exempt such other persons as are not within the intent of the definition (title I, sec. 45 (a) (16), incorporated in title II by sec. 203).

Every prohibition of the title is made to depend on actual use of the mails or facilities of interstate commerce.

Investment advisers are prohibited from using the mails or interstate commerce in connection with their business unless they register with the Commission. However, an adviser whose clients are all residents of the State in which he has his principal office and is doing business, and who renders no service as to securities trade on national exchanges, or in over-the-counter markets out of the State in which he is doing business, need not register.

An adviser may be denied registration, or his registration may be revoked or suspended, if he has within 10 years of the issuance of the order been convicted of a crime involving securities transactions, investment advice, underwriting, securities brokerage or dealing, or in connection with his employment or affiliation with an investment company, bank, or insurance company; or if he is under injunction against engaging in specified activities involving substantially the same matters; or has omitted to state in his application the facts required to be stated; or has willfully made untrue statements or material omissions therein.

The bill provides further that registered investment advisers may not use the mails or means or instrumentalities of interstate commerce—

(*a*) To make contracts containing provisions for compensation based on a share of the capital gain on, or capital appreciation of the client's funds, or permitting assignment of the contract by the adviser;

(*b*) To employ any device, scheme, etc., to defraud a client or prospective client or engage in any transaction, practice, or course of business which defrauds, or would operate to defraud a client, or prospective client;

(*c*) Knowingly to buy or sell to or from a customer any security unless the adviser is a member of a Maloney Act association;[1] or

(*d*) If he is a member of such an association to effect any such transaction unless he discloses at or before the completion thereof the capacity in which he has acted.

I. *It is regulation of interstate commerce.*

The activities of investment advisers are within the power of Congress to regulate interstate commerce. The investment advisers' business involves, habitually uses the facilities of, and profoundly affects, interstate commerce.

The bill sets forth, as legislative findings (which will be given great weight by the courts in a consideration of the validity of the regulation (*Borden Farm*

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[1] See sec. 15A of the Securities Exchange Act of 1934, as amended.

Products Company v. *Ten Eycke*, 297 U. S. 251; *Chicago Board of Trade* v. *Olsen*, 262 U. S. 1; see *Norman* v. *Baltimore & Ohio R. R. Co.*, 294 U. S. 240, 311; *Electric Bond and Share Co.* v. *S. E. C.*, 303 U. S. 419)) that the usual course of business of investment advisers is carried on by the use of the mails and facilities of interstate commerce; that their advice customarily relates to securities, traded nationally over exchanges and other securities markets, of issuers engaged in interstate commerce; that their advice affects the policies of large financial institutions engaged in banking and interstate business; and that the volume of transactions affected by their advice is so large as to have a vital effect on the national economy (sec. 201).

The report of the Securities and Exchange Commission on Investment Advisers (H. Doc. 477, 76th Cong.) supports these findings.

Investment advisers commonly make use of facitities of interstate commerce and of the mails in the course of business. One class of adviser relies primarily on the use of publications and bulletins for the dissemination of investment advice to clients (report, pp. 20, 21). The other class, though furnishing personalized service, frequently renders advisory opinions through the use of the mails for ultimate action by the client. Such advisers customarily prepare and distribute to their clients as well as to nonclients, financial bulletins, economic surveys, and monographs (report, p. 21). Solicitation of new clients is commonly effected through the use of the mails, by brochures and other advertisements describing the nature of the services offered and their advantages (report, p. 19). The fact that at present 33 investment adviser firms maintain a total of 86 branch offices indicates the extent to which these firms necessarily make use of the facilities of interstate commerce (report, p. 7).

Regulation of the foregoing activities is clearly within the legislative powers granted the Congress by the commerce clause of the Constitution. The dissemination of information across State lines is interstate commerce (*Western Union Tel. Co.* v. *Foster*, 247 U. S. 105; *International Text Book Co.* v. *Pigg*, 217 U. S. 103; *International Text Book Co.* v. *Peterson*, 218 U. S. 664); and the scope of the power of Congress to regulate interstate commerce extends to the business of supplying information or services through the mails or facilities of interstate commerce to persons in other States. *Associated Press* v. *N. L. R. B.* (301 U. S. 103). The Grain Futures Act, section 6, prohibits, save under certain conditions, the transmission of price quotations relating to futures. Although the Supreme Court, in *Chicago Board of Trade* v. *Olsen* (262 U. S. 1) found no occasion to discuss this particular point, it upheld the Grain Futures Act as a whole (262 U. S. at 42).

II. IT IS REGULATION OF ACTIVITIES AFFECTING INTERSTATE COMMERCE

Even if the investment advisers did not, in the course of their activities, make use of the instrumentalities of interstate commerce, they would still be a proper subject of Federal regulation. One cannot engage in conduct which profoundly and directly affects interstate commerce, and escape the regulatory power of Congress over that commerce (*Northern Securities Co.* v. *United States*, 193 U. S. 197; *Minnesota Rate Cases*, 230 U. S. 352; *United States* v. *Ferger*, 250 U. S. 199; *New York* v. *United States*, 267 U. S. 591; *Colorado* v. *United States*, 292 U. S. 522; *N. L. R. B.* v. *Jones Laughlin Steel Corp.*, 301 U. S. 1; *Santa Cruz Fruit Packing Co.* v. *N. L. R. B.*, 82 L. Ed. 653). That the business of investment advisers does have a profound effect on interstate commerce and the national economy is demonstrated, it is believed, by the Commission's Report.

The amount of funds supervised by investment counsel firms actually exceeds the amount managed by investment companies. Only 51 investment advisers (out of a total of 394 considered in the Commission's study) supplied the Commission with information of the amount of funds they supervised. These 51 firms supervised funds in excess of $3,900,000,000 (report, p. 8). Approximately one-third of this amount represents funds of investment companies, banks, and insurance companies largely invested in securities for which national markets exist.

The giving of investment advice does determine in actual practice the direction in which the vast amount of capital subject to the advice of investment advisers will flow in the channels of the national economy. It is not uncommon for investment advisers to accept and recommend to clients that they be vested with discretionary powers over their accounts (report, pp. 13, 14). Such powers imply the

making of the ultimate determination with respect to the sale and purchase of securities for the client's portfolio. In an appreciable number of cases investment advisers are brokers and/or dealers in securities, and as such they not merely order the execution of purchases and sales for their clients' accounts, but themselves execute the orders on national securities exchanges or over-the-counter markets (report, p. 11).

Even in the cases where an investment adviser has only advisory accounts for his clients, it may be assumed that the clients customarily follow the advice of the adviser. It is obvious that the adviser-client relationship will continue only so long as the client, in the great majority of instances, is satisfied with and follows the investment advice he receives. That this is implicit in the adviser-client relationship is apparent from the testimony of the investment advisers who have appeared before the committee It is clear, therefore, that even these investment advisers directly cause the execution of securities transactions on national securities exchanges and over-the-counter markets.

Through their control over the purchase and sale of substantial amounts of securities, investment advisers may shift investments from one industry to another, thus affecting the capital supply that businesses engaged in interstate commerce may command (report, p. 27). The large supply of funds under their supervision may serve to stabilize market in securities (ibid.). Moreover, the forced liquidation which ordinarily follows adverse market conditions may strike overweighted accounts simultaneously, resulting in an intensification of the downward movement of securities prices.

III. IT IS REGULATION OF THE MAILS

The regulatory provisions of title II depend on the use of the mails as well as of instrumentalities of interstate commerce. The power of Congress over the mails is of a proprietary nature. Congress may therefore exclude from the mails matter which it deems objectionable (*Ex parte Jackson*, 96 U. S. 727). Matter used in furtherance of schemes to defraud may be prohibited (*Public Clearing House* v. *Coyne*, 194 U. S. 497). The Supreme Court has recognized that Congress may require, as a condition of using the privileges accorded to publications in second-class mail, that information as to ownership, editors, and circulation be filed (*Lewis Publishing Co.* v. *Morgan*, 229 U. S. 288). The decided cases remove any doubt that Congress, to further a valid policy not directly addressed to postal regulation, may use its power over the mails for that purpose. In *Badders* v. *United States* (240 U. S. 391, 393), Mr. Justice Holmes said:

"The overt act of putting a letter into the post office of the United States is a matter that Congress may regulate. * * * Whatever the limits to the power, it may forbid any such acts in furtherance of a scheme that it regards as contrary to public policy, whether it can forbid the scheme or not."

IV. PARTICULAR REGULATION IS VALID

Since the activities of investment advisers are within the scope of congressional power over interstate commerce and the mails, Congress may require registration as a condition precedent to the use of these facilities to carry on such activities. *Electric Bond & Share Co.* v. *Securities and Exchange Commission* (303 U. S. 419), and cases therein cited. Furthermore, in exercising its power, Congress may properly adopt a scheme of regulation to assure that investment advisers shall not use the mails or interstate commerce to perpetrate fraud upon their clients.[2] (*S. E. C.* v. *Torr*, 87 F. (2d) 446 (C. C. A. 2).)

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[2] There would appear to be no reason for believing that this legislation will be precedent for congressional regulation in other fields which do not present the same national problems. Thus, it is neither sanction nor precedent for the regulation of attorneys who, in the course of their relationships with clients, may find it necessary to render investment advice.

The definition of investment advisers in the bill expressly precludes operation of this legislation as to attorneys. Investment advice rendered by attorneys is often purely incidental to the rendition of legal services. Accounts may be handled by attorneys as fiduciaries, subject to the supervision of probate courts or courts of equity. Frequently, investment advice rendered by attorneys is limited to insuring that fiduciaries shall make up their trust accounts in compliance with the relevant laws of the jurisdiction. In certain States where lists of "legals" are expressly set forth by statute, recourse to an attorney is often necessary to those whose investment policy must be framed pursuant to those lists. It will be noted that attorneys do not solicit investment advisory business, rarely if ever base their fees on the success of an investment account, and for the most part do not give "investment advice" as such. Their advice is, in the vast variety of instances, limited to "legal advice" as to what course of investment conduct is proper for persons in various legal statuses.

Mr. L. M. C. SMITH. Senator, I should like to ask permission to have put in the record a statement on sections 18, 19 (b), and 21 (c), relating to capital structure, which discusses the arguments of the various persons who spoke in regard to capital structure.

Senator HUGHES. Very well; it will be received.

(Memorandum entitled "Provisions of the proposed bill relating to capital structure, secs. 18, 19 (b), and 21 (c)" is as follows: Exhibits referred to are filed with the Committee, but are not herewith printed.)

PROVISIONS OF THE PROPOSED BILL RELATING TO CAPITAL STRUCTURE

(Secs. 18, 19b, and 21c)

THE SENIOR SECURITIES OF LEVERAGE INVESTMENT COMPANIES; ACTUAL EXPERIENCE COMPANIES

THE SENIOR S'CURITIES OF LEVERAGE INVESTMENT COMPANIES; ACTUAL EXPERIENCE COMPARED WITH PROMISED RETURN AND SAFETY

Raymond D. McGrath, the executive vice president of General American Investors Co., Inc., urged that the senior securities of his company must be considered good investments because the bonds and preferred stock of that company are at present selling in the market near their call price. Mr. Quinn of Tri-Continental Corporation objected to the statement by the counsel for the investment trust study that some preferred stocks could be purchased at 50 cents on the dollar, and ci.ed several preferred stocks which had a market value not very far from the liquidating value, to wit:

	Involuntary liquidating value	Market price
Tri-Continental Corporation Preferred	$100.00	$81.00
United States & Foreign Securities Corporation Preferred	100.00	93.00
Capital Administration Co., Ltd., Preferred	50.00	47.50

It will, of course, be observed that in citing these companies these witnesses have mentioned four investment companies whose preferred stocks stand among the highest on the market in the entire investment-company industry. The February 19, 1940, issue of Barron's the National Financial Weekly states (exhibit A):

"With one or two notable exceptions, current prices (of investment-trust preferred stocks) are 20 to 40 percent below the amounts which holders of these securities would receive if the assets of the companies were liquidated at present market prices."

The table of 16 selected investment-company preferred stocks presented in this publication shows at December 30, 1939, a market discount from asset value of 58 percent in one case, 50 percent in another, and 44 percent in a third instance. That list contains, amongst the 16, the 4 companies cited by Messrs. McGrath and Quinn and shows that the discounts on December 30, 1939, in those very securities were:

	Percent
Tri-Continental Corporation preferred	22
Capital Administration Co., Ltd., preferred	20
United States & Foreign Securities Corporation preferred	16

General American Investors Co., Inc., was the only company whose preferred stock was selling at a slight premium, to wit, 2 percent.

It would seem rather difficult to make out a case for the investment merit of the preferred stocks of investment companies for the period of the history of these companies. Even the holders of many of the most choice of the investment-company preferred stocks are at present, and have been for years, unable to

realize on the market the face amount of their security. Barron's publication, in introducing the statistics on the investment-company preferred stocks referred to above, states:

"If there is a 'forgotten security', the preferred shares of management investment trusts must be considered among leading contenders for the title."

In order to judge the fulfilment of the promises on which the preferred stocks of investment companies were sold, the history and status of the preferred stocks in general—and not the preferred stocks of 4 or 16 selected stocks—must be scrutinized. In the matter of arrearages, a survey of 58 investment companies with preferred stock outstanding (68 issues) shows that at the end of 1939, 35 companies were in arrears with respect to the payment of dividends on 40 issues, these arrearages aggregating $78,985,693.[1] Of 749 preferred-stock issues of noninvestment companies registered under the Securities Act of 1934, 234 were in arrears at the end of 1937, or 30 percent.

In addition to the failure in so large a proportion of cases to pay the stipulated dividend on the preferred stocks, investment companies have in a surprisingly large proportion of cases failed to preserve the principal or face amount of the investment of the preferred-stock holder. While out of Barron's selected list of 16 preferred stocks, 2 were "under water" on December 31, 1939, a recent check on 68 preferred issues shows that 33 of the issues were "under water" on December 31, 1939. That is to say, in the case of almost 50 percent of the preferred issues, the companies did not have enough assets to pay the involuntary liquidating value of these securities.

Mr. Quinn of Tri-Continental Corporation questioned the statistical procedure employed by the investment trust staff to show that investment companies could not be expected to earn as regular income the rate that these companies promised to pay on their senior securities. He did not, however, attempt to challenge the fact that, in the overwhelming majority of cases, the investment companies have in actual fact failed to earn a rate of regular income equal to the rate on their senior securities. There is annexed hereto a table (exhibit B) which shows that, out of 71 companies with senior securities at the end of 1938 (admittedly a year of poor earnings, but the latest for which full information was available, there were only 5 which, during that year, earned net, after operating expenses, 5 percent or more on their total assets; there were only 13 which earned 4 percent or more on their total assets. The average (median) rate of net ordinary income (after operating expenses and taxes other than Federal income tax) was 2.47 percent.[2] These rates of earnings may be compared with the dividend and interest rates promised on the senior securities of these companies, shown in the annexed table (exhibit B). Of the 111 senior issues, 99 carried a rate of at least 5 percent.

It is also very instructive that an analysis of a sample consisting of 17 leverage investment companies shows that during 1937, 1938, and 1939, 10 of these companies could not meet their senior interest and dividend requirements out of a combination of ordinary income and capital gains in any one of these 3 years (exhibit C). We are not speaking now of rate of earnings compared with rate of fixed charges but the actual earnings of the company on its entire capital. In short, with the use of their whole capital, 10 companies could not earn enough from both regular income (to wit, interest and dividends on their investments) and capital gains (i. e., profits on the purchase and sale of securities) to meet the actual charges on their senior securities during any one of these years.

We note that among these 17 companies is Tri-Continental Corporation, the company of which Mr. Quinn is executive vice president. The percentage

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[1] Default in the payment of dividends on preferred stocks has been a common phenomenon among investment companies for the past decade. Out of a total of 92 leverage investment companies, 75 passed a dividend on their preferred stock in the period 1927–35; out of 117 issues of preferred stock by these companies, 98 passed a dividend. Thirty-six of the issues failed to distribute dividends for a period as long as from 3 to 4 years; 26 from 2 to 3 years. Since these preferred stocks were outstanding on the average for only somewhat over 7 years, it appears that they failed to pay dividends during about one-half of their life. In the year 1935 the 92 management investment companies failed to pay current dividends amounting in the aggregate to $19,700,000. In the years 1932 to 1934, inclusive, these companies fell short more than $20,000,000 each year in the payment of current dividends on their preferred stock.

In addition, these defaults do not include the instances where payments were made from paid-in surplus or capital surplus created by a restatement of capital, tantamount to merely a return of capital.

[2] Over the period 1930–36, net ordinary income of management investment companies proper averaged only 3 percent of total assets at market value.

of net ordinary income to average assets in that company was as follows: 1936, 4.5 percent; 1937, 4.3 percent; 1938, 2.4 percent; 1939, 3.2 percent.

On the debentures the company had to pay 5 percent; on the preferred 6 percent. Its net ordinary income fell short of the senior charges in 1938 and 1939; was adequate in 1937. Net income, including realized capital gains and losses, fell short of the amount required for fixed charges in 1939; was adequate in 1937 and 1938.

Selected Industries, Inc., which is an investment company affiliate of Tri-Continental Corporation, and which undertook to pay a 5½ percent dividend on its prior preferred stock and a 5 percent dividend on its convertible preferred stock, earned the following rates of net ordinary income to average assets: 1937, 3.8 percent; 1938, 3 percent; 1939, 3.8 percent.

The entire net ordinary income was insufficient to pay the required dividends on the preferred stocks in any of these 3 years.

Capital Administration Co., Ltd., another investment company affiliate of Tri-Continental Corporation which has a preferred stock with a dividend rate of 6 percent, earned a net ordinary income bearing the following percentage relationship to average assets: 1937, 4 percent; 1938, 2.7 percent; 1939, 3.6 percent.

As the dividend requirements on its preferred stock totaled only $130,200, the net ordinary income was sufficient to pay that dividend.

General American Investors Co., Inc., whose preferred stock had the highest market standing, earned as the percentage of net ordinary income to average assets: 1937, 3.6 percent; 1938, 2.5 percent; 1939, 2.8 percent.

The net ordinary income was insufficient to cover the fixed charges in 1938, and sufficient in 1937 and 1939.

United States and Foreign Securities Corporation, which was mentioned by Mr. Quinn as one of the companies whose preferred stock had a particularly high market standing, earned: 1937, 4.5 percent; 1938, 3.5 percent; 1939, 3.9 percent.

Its net ordinary income was sufficient to cover the senior security requirements in 1937, but insufficient in 1938 and 1939. The net ordinary income, including capital gains, was insufficient to cover the fixed charges in 1938 and 1939.

The 17 companies combined failed to earn an aggregate ordinary income sufficient to meet their total senior requirements in any one of these years. Their aggregate net income including capital gains also fell far short of meeting their total senior requirements.[3]

The data show very clearly that the leverage investment companies almost invariably fail to earn a regular income at a rate sufficient to justify the charges on the senior securities. It would appear that the foregoing is a sounder explanation why the preferred shares of investment companies constitute the forgotten security than the theory that it is due to the fact that investment companies have been studied by the Securities and Exchange Commission, as suggested by one of the witnesses before the Committee. The public disfavor into which the preferred stocks of investment companies have fallen may be in part attributed to the heavy losses suffered by preferred stockholders in the years following 1929, and the realization by a greater part of the public of this basic economic unsoundness of the senior securities of leverage companies.

It might be added here that, if there is no economic justification in the rate of earning power for senior securities of investment companies, there is a logical basis for not permitting the issuance of additional senior securities rather than limiting the relative proportion of senior securities n the capitalization. There would appear to be no reason why an investment company should be permitted, in effect, to promise to the contributors of even one-third of its capitalization that it will pay them 6 percent or 5½ percent for the use of their money, when the investment company can reasonably be expected to earn on the average only 2 or 3 percent on that money.

THE COMMON STOCK OF LEVERAGE INVESTMENT COMPANIES

Several witnesses from the industry appear to have assumed that the sole reason for recommending the prevention of the issuance of additional senior securities in the investment company field is the desire to protect the senior

[3] For the 17 leverage companies combined, net ordinary income would have had to increase by 25 percent in 1937, 108 percent in 1938, and 79 percent in 1939, in order for these companies to meet their senior requirements.

security holder. As a matter of fact, it is the weakness of the common stock of the leverage investment company, the extreme dangers to which that stock is exposed, and the lack of investment merit in that security that requires a prohibition upon the possible expansion of the multiple-security investment company. The end sought by section 18 in preventing the further issuance of senior securities is at least as much the prevention of the marketing of additional leverage common stocks as the senior securities of leverage investment companies. It is true that existing leverage companies have the right to issue additional common stock, but issuance of additional common stock by existing leverage companes serves to reduce the dangers to both the existing common stock and senior securities of those companies; whereas the issuance of additional senior securities would increase the dangers of both types of securities.

If one is to scrutinize the investment merit of the securities of leverage companies, it is not adequate to examine the status merely of the preferred stock of such companies, as some of the witnesses before the subcommittee have done; but it is necessary to investigate the history and status of the common stock of leverage investment companies. Since such companies issue these different kinds of securities to the small investor—of whom so much has been said—in exchange for his savings, it would seem that these companies have a responsibility also to that part of the public which entrusts its funds to them in return for the common stock.

The Commission believes that it has been clearly shown that it is the leverage aspect of the senior-junior capital structure in investment companies—a condition which, of course, does not exist in the single stock company—which may be held accountable for a large part of the losses which have been suffered by the investor who purchased the common stock of the leverage company.

The common stock of a leverage investment company is a very volatile and hazardous security. When the securities market is rising, the common stock has the advantage of trading on the senior security capital and receiving the major part of the market appreciation. This naturally causes a great rise in asset value and generally in the market price of the common stock. If an investment company which has been capitalized at a 3 to 1 leverage ratio (i. e., when the senior securities represent $600,000 and the common stock represents $300,000 of the contributed capital) makes a profit within the first year of operations of 10 percent on its total assets (to wit, $90,000 over the fixed charges), this entire increase in assets inures to the common stock, which has thus earned 30 percent on its invested capital. On the other hand, a 10 percent loss on the whole fund, after fixed charges, is reflected in a 30 percent loss on the common stock capital investment—hence, volatility is always present with leverage.

Both the sharp rises and the sharp declines in assets will have a repercussion on the market price of the common stock. Because of the leverage influence, a substantial swing of the securities market is likely to deprive the common stock of a leverage investment company of both its asset and market value.

The volatility of the common stock of leverage investment companies accounts for a considerable part of the losses sustained by investors. The statistics on market prices are very eloquent on this point. The average dollar invested in July 1929 in the common stock of leverage investment companies had declined to about 2 cents in value in June 1932. At the end of 1937 it was worth 5 cents, and was worth approximately 5 cents at the end of 1939. On the other hand, the average dollar invested in the common stock of nonleverage investment companies fell only to 21 cents in June 1932, was worth 48 cents at the end of 1937, and about 47 cents at the end of 1939. While the investor who bought a share of common stock of a leverage investment company in July 1929, had, on the average, lost 95.1 percent on his investment, the purchaser of a share of nonleverage common stock had lost only 52.7 percent. (Exhibit D.) It may be relevant to point out that had investment companies been simple structure companies exclusively, a very substantial part of the losses sustained by investors in the common stock would have been avoided.

In this connection, we would like to note the difference in the percentage of shrinkage of the asset values of the common stock of leverage and nonleverage companies. Of course, the equity of the common stock of both leverage and nonleverage companies shrank between 1929 and 1935; but the shrinkage in the asset value of a dollar invested in the common stock of leverage companies was 79 cents, while that of the nonleverage companies was 28 cents—or over three times better for nonleverage.

The conclusion to be drawn from the operation of the principle of leverage and from these statistics is that the common stock of leverage investment companies is so fraught with danger to the investor and so hazardous a commodity that it is definitely inappropriate as an offering of a public investment institution, especially upon consideration of the sales emphasis of investment companies upon the savings and investment character of the securities of such companies.

It might be interesting to note some of the vicissitudes of the common stock of General American Investors Co., Inc., in connection with which Mr. McGrath observed that it "has a book value which is higher than the price at which it was originally offered to the public" although "it is selling at a substantial discount from its book value in line with all other stocks of closed-end investment trusts." On December 30, 1939, the common stock of that company had an asset value per share of $11.81, and was selling at a market price of $5⅝. In making the statement that the common stock has at present a book value greater than the price at which the common stock was originally offered to the public, Mr. McGrath referred to the price of $10 per share which the public paid for such common stock as it received in the original distribution. However, the investing public, which bought the common stock that the sponsors disposed of on the market at the prevailing high prices, paid a price much higher than $10 per share.

It must be noted that as rapid as may be the ascent, under favorable circumstances, of the market prices of equity stocks in a complex capital structure, at least as rapid will be the descent of these equity stocks, when the purchasing public reaches the end of its optimism. Before such time, however, the sponsors, in many instances have disposed of a significant portion of their holdings to the public at large profits.

The present General American Investors Co., Inc., is the result of the merger in 1929 of the initial General American Investors Co., Inc., with Second General American Investors Co., Inc. In the merger, Second General American Investors Co., Inc., assumed the debentures of the original General American Investors Co., Inc., and exchanged its common stock for that of General American Investors Co., Inc., on a share-for-share basis.

The initial company, General American Investors Co., Inc., was originally created in the State of Delaware on January 25, 1927, with $9,000,000 in senior securities as against $300,000 in common stock—a leverage ratio of 31 to 1.[4] The public put in $7,500,000 for which they received $7,500,000 of debentures and warrants entitling them to 75,000 shares of common stock which were later exercised. The sponsors put in $1,800,000 for which they received 15,000 shares of preferred stock at par and 125,000 shares of common stock. However, although part of the sponsors' contribution was in the form of the preferred stock, all of the sponsors' contribution was in a junior position to the public's contribution in the debentures. The ratio of the public's contribution to the sponsors' contribution was 4.16 to 1.

The effect of this leverage structure of the original company in a period of rising prices became apparent in the impetus given the equity stock marketwise. The market price of the common stock had ranged in 1928 from a low of $56⅛ in February to a high of $88⅞ in December. These values represented substantial premiums over the stock's asset value of $9.26 per share at the beginning of the year and $25.39 per share at the close of the year.

The sponsors, taking advantage of the high level in market price attained by the common stock in December 1928, disposed of 18,620 shares to the public for $1,365,221,[5] or at a profit of $1,320,533 over the original cost to the sponsors of these shares. Thus, by disposing of this portion of the 125,000 shares originally taken down, the sponsors realized a profit of $1,065,221 over the cost to them of the entire block. However, it must be noted, the sponsors retained by far the largest part of their holdings and subsequently, when the market

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[4] The initial company sold $7,500,000 of 5 percent debentures to the public. The debentures carried nondetachable warrants entitling the holders to receive, without cost, 75,000 shares of common stock. The sponsors purchased $1,500,000 par value of 6 percent cumulative nonvoting preferred stock (15,000 shares). There were issued to the 2 sponsors for an assigned consideration of $300,000, 125,000 shares of common stock. The sponsors paid $1,800,000 in all for the preferred stock and their common stock.

[5] Subsequent to subscribing originally to 125,000 shares and up to this disposition, the sponsors had purchased 5,100 shares at average market prices and had sold 3,680 at about average prices. Some shares of the balance therefore might have been included in the 18,220 shares sold at this time.

declined, faced losses far larger than the profits made—of course, the record does not indicate the extent, if any, to which the original investing public realized any profits.

The investing public which had bought these shares from the sponsors at an average price of approximately $73 per share was faced with severe losses both in asset and market value in the period of deflation following 1929. By the end of 1932 the common stock of the present General American Investors Co., Inc., had fallen to a low of 13 cents per share in asset value. On December 30, 1939, the asset value of a share of common stock of the present company was $11.81, and the market price was $5⅝.[6]

A like procedure was followed with the Second General American Investors Co., Inc. By disposing of 178,165 shares of this common stock for $3,004,818, the sponsors realized a profit of $1,223,168 above the cost of the shares sold. The purchasers paid an average of $16.87 per share. As stated, at the end of 1932, this stock had an asset value of but 13 cents per share, and on December 30, 1939, the asset value and market price of the common stock were $11.81 and $5⅝ respectively.

In connection with how the leverage investment companies have served the public holder of the comon stock, it is interesting to note that even the best performing companies which have managed to pay dividends on senior securities have either entirely failed to pay any dividends, or paid an occasional trivial dividend to the common stock, since the period of the market decline. The witness from General American Investors Co., Inc., announced in his opening remarks that his company had paid out $6,774,925 in dividends in a period of 13 years. However, only two dividends—one dividend of 75 cents per share and another of 25 cents per share—were paid on the common stock of that company since its formation. The first dividend was paid on December 19, 1936, to stock of record December 15, 1936, and the second dividend was paid on December 22, 1939; no dividends had been paid prior thereto, and none had been paid thereafter. As to the companies with which Mr. Quinn is associated—Tri-Continental Corporation and its subsidiaries, Capital Administration Co., Ltd., and Selected Industries, Inc.—the following are the earnings which the common-stock holders have reaped:

Tri-Continental Corporation.—Initial dividend of 25 cents per share paid October 31, 1936; December 24, 1936, and July 1, 1937, 25 cents each; none thereafter.

Capital Administration Co., Ltd.—This company, in addition to a bank loan and a cumulative preferred stock, has class A and class B common stock. The class A common stock is in reality a senior security because it has a priority claim of $20 per share in involuntary liquidation. Since the class A stock has only a per share asset value of $12.29, it is really "under water" at the present time.[7] The dividends paid on the class A and the class B stock have been as follows:

Class A: Initial dividend of 50 cents per share paid October 31, 1936; December 24, 1936, and June 14, 1937, 50 cents each; none thereafter.

Class B: Initial dividend of 12.8 cents paid October 1, 1936; December 24, 1936, and June 14, 1937—12.8 cents each; none thereafter.

Selected Industries, Inc.—No dividends have ever been paid on the common stock. At the end of 1939 there were accumulated arrears of $10 per share on the cumulative convertible stock. The prior preferred was $10 a share "under water." The convertible preferred had no asset value whatever.

U. S. & Foreign Securities Corporation.—The other investment company mentioned by Mr. Quinn as showing a particularly meritorious performance—no dividends on the common stock have ever been paid. At the end of 1939 there were arrears of $57 on the second preferred stock.

Attributes of investment companies which make the regulation of their capital structure especially significant.—Cyril J. C. Quinn, executive vice president of Tri-Continental Corporation, inquired why the capital structure of investment companies should be subjected to Government regulation whereas the capital structures of other corporations are not restricted.

"Now, where, in any of these sections, is there any characterization of investment-company senior securities which can be differentiated in the slightest from the senior securities of any American form of business? If they are inequitable provisions and if they are bad, they are bad for every industrial company and not only for the investment companies. If control or management is irrespon-

[6] These sales were made prior to the distribution of a share-for-share stock dividend. Hence, the market price of two shares must be used in comparison with the sales price.

[7] It should be noted that, although the class B common stock has no asset value (and the class A stock is "under water"), the class B stock still has the right to elect two-thirds of the board of directors.

sibly held, it can be just as bad for an industrial company as it can be for an investment company.

"Nobody disputes the fact that borrowing and issuance of senior securities may tend to increase the speculative character of junior securities, but how in the world can this be said to apply to investment companies any more than it can be said to apply to any business?

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"In the declaration of policy and in the discussion of section 18 here, there has been no single important reason adduced regarding the senior securities in an investment company which cannot with equal force and equal validity be applied to all companies in all businesses.

"The important question is thus squarely posed:

"Is Congress prepared to say that there is something so intrinsically wrong with senior securities generally that their future issuance can be prohibited?

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"The next argument that they advance in favor of abolishing senior securities in the future is that there are arrearages in senior securities outstanding in the investment companies at the present time, and that some of them are under water: that is, the assets of the company are not included in the outstanding obligations.

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"What is the inference of the argument? Are railroad bonds to be legislated out of future existence because a substantial portion of the outstanding bonds of railroads are in default? Are preferred stocks of industrial companies to be washed out in the future because during the depression a great many of them passed their dividends and have since failed to make them up?"

INVESTMENT COMPANY POOLS AND THEIR RESEMBLANCE TO "TRUST FUNDS"

We are not dealing with anything but investment companies. We reiterate that investment companies are trusts of money from the public which the company invests for what in a sense are its clients. It is because Congress looked at this matter of individuals putting their savings into the hands of others for investment as something different from an investor deciding that a particular steel manufacturing concern was a good investment (and hence either lent his money to the company on a bond or preferred stock,[8] or sought to participate in its surplus profits) that Congress directed an inquiry into the manner in which these companies recruited their funds and the manner in which the contributors of the funds had been served.

The witnesses from the industry have brought into issue a really fundamental question, to wit: Is the Government justified in exercising a greater protective jurisdiction over funds which are solicited and sought to be handled by these investment companies than over investments which people deliberately make in specific industrial enterprises? Congress apparently thought there was a difference because it directed the Securities and Exchange Commission to study the capital structure and financing of investment companies and not senior securities in general.[9]

Our primary answer to this cardinal question is that the people who put their money into investment companies are not really investing in the company but are entrusting their funds for management—they are in a broad sense cestuis que trust of the management and not individuals who are lending their money to or are adventurous in a specifically defined and particularized industrial enterprise.

The industry has peculiar responsibilities which it owes to the public in the matter of the terms and conditions upon which an investment company shall solicit money from the public and in the matter of fulfilling the obligations it has assumed.

It is suggested that the manager has no more responsibility than if he were seeking to interest an investor in an automobile factory or a bus line. But it is traditional that the law shows greater concern for people who entrust their money to other people to handle it for them than for people who invest their money in a specific enterprise. Greater supervisions and more restraints are imposed in the former category.

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[8] We cannot get away from realism—a preferred stockholder is essentially (although not legally) a lender of money without a due date because he rarely is allowed more than the fixed dividend.

[9] Eminent authorities on finance have argued that preferred stocks in general are poor investment securities and have also argued that the burden of fixed debt has a demoralizing influence on industry, but it is not necessary for us to take any side on this general controversy.

Banks are segregated from other industries, in the matter of restraint, because they accept money from the public without that money being dedicated to a specific industrial enterprise, and the recipient would hence be free to utilize the fund in any manner it wishes. Insurance companies are under restraint because money is entrusted to them to be continually handled by them as money and not to be devoted to some industrial enterprise. In short, the continuous handling of money of others is a ground of differentiation between institutions engaged primarily in this practice and the ordinary industrial enterprises, and it is in the former class that the Commission believes investment companies belong.

Thus there is a reasonable basis for maintaining that organizations which hold themselves out as the managers of funds which will be entrusted to them shall be restricted in the terms that they offer to their investors; to justify the above restriction it is unnecessary to show that organizations which are operating a particular industrial enterprise should similarly be restricted in the terms which they may make with those who wish to participate in that enterprise.

Investment company assets remain liquid pools.—Thus it appears that the law and statute tend to exact a greater fiduciary obligation from individuals or organizations which are supposed to preserve the liquid form of the money which is entrusted to them than from individuals or institutions which immediately transform the capital contribution into an agreed-upon productive or operating enterprise. The readily liquidable character of the assets of investment companies is a feature which vitally distinguishes these companies from the railroad companies and industrial enterprises with which it is sought to compare them. This characteristic of liquidity of assets makes the supervision of the relationships of the sponsor to the investor particularly necessary in the case of investment companies. In the first place, the investible funds, the trust res, so to speak, is subject to ready alienation, negotiation, or spoliation, whereas in the ordinary enterprise the greater part of the assets consists of property in a stable form such as refineries, smelters, glass furnaces, steamships, real estate, which are protected by documents of title, difficult of removal or exchange, and easy of identification. In the second place, because the sponsor or manager always has a large liquid pool of money at his disposal and he is not hemmed in by the limitation of a particular industrial enterprise, there is practically no restriction upon the uses or purposes to which he can put the fund. The fact of the liquidity of the assets of the investment companies and the further fact that the activities of the investment companies are unfettered, make the conflict of interest between the junior and senior securities of investment companies a far different matter than the conflict between such securities in other corporations.

Conflicts of interest continuous and acute in investment companies—only occasional in industrial companies.—Mr. Quinn's argument continues as follows:

"They next say that they want to eliminate senior securities in the future because there is an inherent conflict of interest between the junior security holders and the senior security holders. Now, of course, the interest of the senior security holders are not identical with those of the junior security holders. That is why they spell out these respective rights and privileges in a contract. But in what respect, gentlemen, is this different from the senior securities generally in any business?

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"Now they say that an investment company ought to be a mutual enterprise. This word "mutual" appears in their report, but I must confess that I don't understand exactly what they mean. The report reiterates the belief that there is a conflict of interest between different types of securities, imposing conflicting duties on management because the risks, losses, and gains are not equally distributed. In what respect does this differ from the senior security in any enterprise? To be logical, you'd have to extend this principle to every form of American business."

It is true that the potentialities of a conflict of interest may exist in the case of *any* corporation between the senior securities which can generally look forward to only a fixed and limited return and hence tend to favor a conservative policy and the equity securities which are entitled to all of the surplus profits and hence tend to favor a more speculative policy. But, this conflict rarely comes to bear upon the actual activities of industrial companies because the activities of such companies are definite, circumscribed, well established, and generally acceptable to all types of security holders. Compared to the possible variation of activities of investment companies the distinction be-

tween running a specific industrial enterprise in a conservative or a speculative fashion is relatively minor. While any corporation may from time to time oscillate—within a narrow orbit—between a somewhat more or less conservative policy in the conduct of its established line of activity, it cannot, like an investment company at the present time, within a few days entirely change the character of its activities, for example, from the use of its assets in diversified investment to speculative trading or to the financing of a single hazardous special interest. In short, while this conflict is possibly latent in the case of other companies the conflict in the case of investment companies is continuous and acute.

The same thing is true in connection with the inequities which, it has been shown, managements of multiple-security investment companies have perpetrated upon certain classes of security holders. It is quite true that "inside" interests of any multiple security company might be tempted to engage in practices favoring their particular type of shareholdings at the expense of other classes of shareholders or in disregard of the interest of the latter. Nevertheless, while the opportunities for such conduct occasionally arise in the case of operating, commercial and industrial enterprises they are ever-present and more easily available in the case of investment companies.

The holder of the control stock of any corporation may sell that stock at a premium, but that transfer is not as likely, as in the case of an investment company, to constitute the selling of the rest of the security holders "down the river," as the newcomer will not be getting control of a liquid fund which can be employed in innumerable ways, but of an enterprise of a well defined character. Cash dividends can be paid out of contributed capital and repurchases consummated in the case of any corporation, but the investment company is generally much more susceptible than other companies, as all of the assets of an investment company are in a form to be utilized for such purposes, whereas other companies, especially in periods of unsuccessful operation, usually have very little cash that might be employed in this fashion. There is little to motivate the controlling interest of an industrial company to take over a competitor or a company engaged in a closely related activity other than the prospect of prosecuting the same business on a larger scale or in a more efficient manner. The fact that investment companies constitute large pools of cash which may readily be put to any use serves as a motivation for sponsors of one investment company to acquire other investment companies so that they might deal with the assets of the acquired companies (and the rights of other security holders) as freely as with the assets of their own company.

It seems quite obvious that an opportunity to effect a shifting of asset values between classes of security holders or a prejudicial readjustment of rights and safeguards of the various classes of securities by the acquisition of other companies, or by mergers and consolidations is greater in the case of investment companies and investment-holding companies than in the case of ordinary industrial or commercial corporation. For the latter types of companies to consummate a merger or consolidation, problems of cash resources, disposal of equipment and physical properties, and coalescence of function must be solved. Investment companies, constituting, as they generally do, large pools of liquid assets and being practically unrestricted in the nature of their operations can much more readily engage in the acquisition of other investment companies or the consummation of mergers and consolidations with other investment companies.

The above is suggested in connection with the argument advanced by the apologists for the multiple-security capital structure in investment companies to the effect that control by a management which itself holds a greater proportion of common stock than senior securities is a common phenomenon in corporate life, not in any way limited to investment companies. The answer to this contention is, that whereas the senior security holders of other corporations may occasionally be prejudiced by specific acts of such a management, in the case of an investment company the entire policy of the company may be predicated upon and the entire welfare of the senior security holders be dependent upon the character of the capital structure and the pattern of distribution of the various types of securities among the sponsors and the outside public.

The discretion granted the Commission under the proposed act to require an equitable redistribution of voting privileges when existing distribution is inequitable.—The investment trust study disclosed that a considerable part of the investment company industry was organized in such a manner that a large

part of the contributors to these funds received no voice in the direction of the management of the company, and that, on the other hand, sponsors and promoters who invested a very minor part of the total contribution placed themselves in the exclusive position to determine the policies and activities of the companies. As a result of the study the Commission concluded that this unbalanced allocation of voting privileges—the fact that a substantial proportion of security holders were disfranchised of any voice and the fact that, for a minor contribution, a certain class of security holders constituted themselves the arbiters of the company—was largely responsible for many of the abuses and defects which developed in the course of the histories of the companies. Such practices as "dumping" and "unloading," hazardous investment projects, consolidations and mergers, dividend and repurchase policies, market operations in the securities of the investment companies—activities frequently very prejudicial to the interests of the classes of security holders which were not given representation—would very largely have been minimized had more representative and democratic voting privileges been extended to the outstanding security holders of the companies.[10]

Since existing capital structures, which were formed on such a pattern, are not disturbed by the proposed bill, it was deemed advisable to lodge in the Commission, after a lapse of 2 years from the effective date of the proposed bill, the power to intervene on behalf of the public investor in such cases where the existing distribution of voting privileges had come to be patently inequitable and constituted a real menace to certain classes of security holders. The bill does not provide for any alteration in the rights of security holders to assets and dividends, nor for the disturbance of any priorities, nor for the modification of the proportions of profits or earnings payable to the holders of the different classes of securities, nor for any additional safeguards for the holders of any of the classes of securities, nor for the diminution of any other advantages which sponsors and promoters may have elicited through the variation in rights and privileges of classes of security holders. The bill, however, would allow the Commission to direct a company in which there is a demonstrably inequitable disfranchisement of outstanding security holders to make a readjustment of voting privileges which would give the disfranchised classes some representation.

Several sponsors of investment companies expressed dissatisfaction with this provisions of the proposed bill. Raymond D. McGrath, executive vice president of General American Investors Co., Inc., said: "We would be forced to accept, pursuant to section 18 (d), whatever restriction of our voting rights the Securities and Exchange Commission might deem to be equitable." In speaking of the possible effect of section 18 (d) as "a restriction of our voting rights" rather than as an extension of some voting privileges to other classes of security holders, Mr. McGrath is not, apparently, viewing the problem from the standpoint of the security holders as a whole, but is obviously identifying himself with sponsors who, by an original disproportionate allocation of voting rights, secured control of investment companies, and may now be reluctant to be subjected to the possibility of any restriction or diminution of their voting preeminence. The contention is made that section 18 (d) may bring about the receipt by certain classes of security holders of a voice in the management not granted them in the original contract, to wit: That voting privileges were not "nominated in the bond" when the sponsors sold certain classes of security holders their securities. It is significant, however, that at the time they testified before the Commission many sponsors acknowledged the existing inequities in the distribution of voting privileges and conceded that a more equitable distribution was extremely desirable for the industry at large.

Christie P. Hamilton, of Illuminating & Power Securities Corporation, testified at the public examination before the Commission:

"A. Well, I think the ideal position would be that the investments should have votes according to the actual cash invested, largely.

"I don't know how it could be worked out underneath the corporation laws of the various States so that that could be brought about, but in my experience I think we have a situation where stockholders have investments, and certain rights have been taken away from them. They have created privileged stocks which have the characteristic of a bond without any vote and then they create a large

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[10] Part Three, Chapter V of the Report contains many examples of the immediate and prospective control of investment companies secured by sponsors with a disproportionately small investment. Chapter V also shows how widespread in the investment company field have been the many advantages to the sponsors and disadvantages to the public investors resulting therefrom.

amount of common stock which will outvote the preferred stock, and therefore a very small investment may have the result of controlling a great deal of capital that is ahead of it. And if everybody is as wise as God, it would be a fine situation to have that control; but we are not.

"Q. I take it you would be against nonvoting preferred?

"A. I think that the man who puts his money in this corporation has a right to vote as he sees fit, and if the management is deemed unfit, that vote should have the power of removing that management. Is that clear?"

Leland R. Robinson of the Founders Group declared in his prepared statement:

"XII. Encouragement should be given to that type of investment company set-up involving a wide public distribution of one type of capital stock, each share possessing a vote; while voting privileges should also be accorded to preferred stock in such a way as to minimize the opportunities to swing control of large amounts of capital through possession of dominating blocks of common stock.

"V. An end should be put to any special types of promotional or control stock, at least in connection with investment companies offering their securities to the public as investment trusts. The capital structure should be simple and clearly defined."

Floyd B. Odlum, of Atlas Corporation, declared in his prepared statement:

"I also think that directors should represent all stockholders and not any class or group and, consequently, that so-called minorities should not be left either in theory or practice without representation."

Morton H. Fry, of Reliance International Corporation, testified:

"Q. But you state in that letter, 'It has always seemed to me to be somewhat questionable to have the stock which has paid in such a small amount of money to have such a disproportionate voting power.'—A. I think that was rather a loose use of the word 'always.' It may be due to the fact that 1930, 1931, and 1932 seemed interminable. I don't know.

"Q. What is your present view on that? Do you agree with Professor Ripley of Hardvard, that the people who put up the money should have the voting control?—A. I most certainly do. I most certainly agree that the people who put the money should have voting control."

It might be pointed out at this time that section 18 (d) does not require, even in the proven cases of inequities to which the section might be applied, that senior securities receive voting privileges in the proportion in which they contributed to capital, as some members of the industry recommended. Nor does it require that classes of securities receive voting privileges in the ratio of their current interest in the assets of the company. Under the section, the company can be required to take steps only when the particular condition of the individual company—such as interest or dividend arrearages upon or impairment of principal of senior securities added to the concentration of control in the hands of particular classes of security holders—makes the existing distribution inequitable; and the company can be directed only to effect such a redistribution as will be "equitable" in the light of the special circumstances. There is nothing in the proposed act compelling an *equalization* of voting privileges.

The most patent application of the Section would probably be found to be in cases of classified common stocks, i. e., where a security has been labeled as a common stock and has been deprived of any voting power, whereas another type of common stock, though having no asset value, is entitled to all or the major part of the voting power.

Earle Bailie, president of Tri-Continental Corporation (Mr. Quinn, the executive vice president of that company testified at length before the committee), testified as follows at the public examination:

"A. That would be an example of what I was talking about. It seems to me anybody who has equity money in it, or in the ordinary course of events there should be one class of common stock, and it should have the same par value and the same voting rights, no matter whom it is owned by. I do not think it is effective or useful to have different classes of common stock. There may be some special cases where that works a hardship, but in general I think the rule should be 'one share, one vote.' "

A special study was made of the relation between voting power and asset value of the "special management stocks" or "class B stocks" at the end of 1939. Of the 11 closed-end companies having a class A and class B stock, the class B stock had no asset value in the case of 5 companies and a very insignificant asset value in the case of 4 other companies. In all but one of the 11 companies the "management stock" holds effective voting control, the one exception being American

Capital Corporation, where the preferred stock has succeeded to exclusive voting power because of arrearages in its dividends; and that company is controlled by Pacific Southern Investors, Inc., which itself is controlled by the voting power of a "class B" stock which has no asset value.

Of the three open-end companies which had classified common stocks, two are controlled by the "managers' shares" which are entitled to only a very small proportion of the assets, while in the case of the third company the "managers' shares" were converted into "investors' shares" on October 11, 1931.

Exhibit E annexed shows in tabular form the comparative rights in distribution and voting privileges of these companies.[11]

An examination of the data on 16 large management investment companies discloses in each case the striking disproportion between the relative equity of various classes of securities in the net assets of the company and the distribution of voting power. (See exhibit F, annexed.) In the case of two companies where the senior securities are "under water" and in arrears with respect to dividends—and, of course, entitled to all the assets of the company—the senior securities have no voting rights at all.[12] In other companies where the senior securities are "under water" and in arrears, the senior security holders who have one vote per share still have no effective voice in the management because of the larger number of common shares outstanding.[13] In the other cases, the senior securities had either no, or a very slight, voting power, although they were entitled on involuntary liquidation at the end of 1939 to all or a great part of the assets of the company.[14]

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[11] The following is a summary of the present status of the voting power in these companies:

CLOSED-END COMPANIES

Capital Administration Company, Ltd.: Preferred, class A, class B: Although class B has no asset value (and class A is under water) class B has the right to elect two-thirds of the board.

Bankers National Investing Corporation: Class A and class B: The class B stock is entitled to 1.98 percent of the assets; has the right to elect a majority of the board.

American Insuranstocks Corporation (December 1937): Preferred, class A, class B: The preferred votes because of arrearages, nevertheless the class B stock having no asset value has 62.6 percent of the voting power.

American Capital Corporation: Prior preferred, preferred, class A, class B: The preferred has exclusive voting power due to arrearages, but 27.9 percent of the outstanding preferred is held by Pacific Southern Investors, Inc., which is itself controlled by an assetless B stock.

Pacific Southern Investors, Inc.: Debentures, preferred, class A, class B: The class B stock which will have no asset value until the company's assets almost double has 76.6 percent of the voting power. This controls American Capital Corporation above.

Italian Superpower Corporation: Debentures, preferred stock, class A, class B: The class B stock although it has an asset value of only $500,000 out of $30,800,000 of assets has exclusive voting power.

Railway and Utilities Investing Corporation: $3 and $3.50 convertible preferred stock, class A, and class B: The class B with no asset value has the right to elect the majority of the board.

Federal United Corporation: Preferred, class A, and class B: The class B which has no asset value has 70.6 percent of the voting power.

The Reserve Investing Corporation (December 1937): Preferred, class A and class B: The class A, which are the management shares, have exclusive voting power although entitled to less than 1 percent of the net assets.

Fairfield Securities Corporation: Preferred stock, class A, and class B: The class B stock, entitled to 30 percent of the assets has the exclusie voting power.

Railway & Light Securities Co.: Preferred stock, voting common stock, and nonvoting common stock; preferred stock has a regular vote per share; only a fractional part of the common stock is disfranchised.

First Investment Counsel Corporation and Third Investment Counsel Corporation give a vote only to the 30 class B shares outstanding in the case of each company. These shares are entitled to only an insignificant proportion of the assets.

Investors Fund C on October 11, 1931, converted the 700 managers' shares into the same number of investors' shares.

[12] General Public Service Corporation; Italian Superpower Corporation.

[13] American Superpower Corporation; Central-Illinois Securities Corporation; Central States Electric Corporation; Commonwealth Securities, Inc.; Selected Industries, Inc.; Standard Investing Corporation; United States & International Securities Corporation; and Western Reserve Investing Corporation.

[14] In United States & Foreign Securities Corporation, the 2 classes of preferred are entitled on liquidation to 78 percent of the net assets. The second preferred is $49 a share in arrears with respect to dividends. Neither of these classes had voting rights at the end of 1939. In the case of General Shareholdings Corporation, the preferred is $8 a share in arrears and is entitled in involuntary liquidation to 84 percent of the total net assets, yet the preferred-stock holders may exercise only 5 percent of the voting rights. The senior security holders in the Equity Corporation are entitled in liquidation to all the net assets, yet the common has 95 percent of the total voting control. In Tri-Continental Corporation, the senior security holders have a 70-percent equity in the net assets, but only 6 percent of the votes. In General American Investors Co., Inc., the debenture and preferred holders together are entitled on liquidation to 46 percent of the net assets; the preferred has 5 percent of the total voting shares.

It should be noted that these unbalanced distributions of voting privileges stem from the patterns of capital structure devised by sponsors and promoters at the inception of the companies.[15]

Paul C. Cabot of State Street Investment Corporation expressed concern that a possible effort in the way of equitable redistribution of voting privileges in specific cases might force "the breaking of many legitimate contracts that have been entered into in good faith by the contracting parties." Eleven years ago, when investment companies were being formed en masse, Mr. Cabot was apparently less impressed with the "good faith" of sponsors who organized investment companies with the public given little voice in the direction of the management of the companies. Mr. Cabot, in an article in the Atlantic Monthly, which has been previously cited at these hearings, wrote as follows:

"Some months ago, in testifying before a committee of the New York Stock Exchange, I was asked to state briefly what were, in my opinion, the present abuses in the investment-trust movement. My reply was: (1) dishonesty; (2) inattention and inability; (3) greed.

"It is of the last of these that I now wish to speak. You may be asked to subscribe to a trust that is both honestly and ably run, and yet find it inadvisable to do so simply because there is nothing in it for you. All the profits go to the promoters and managers."

"There are an infinite number of ways whereby this unduly large slice of the spoils is kept by insiders. They may own all or a very large percentage of the equity stock; they may have warrants and options; or, more rarely, they may be able to take out the money in the form of expenses or managerial fees of one sort or another. * * * *The most common method of accomplishing this result on the part of promoters is an exceedingly complicated capital structure.* There are many investment trust prospectuses in which it takes literally hours to figure just how profits are to be divided. To those not trained in finance

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[15] The discussion by Arthur Stone Dewing (Financial Policy of Corporations) is of interest in this connection:

"*Pseudo-Preferred Stocks.*—This in brief was the original intent of preferred stock, but during the last quarter century, especially in the financing of industrial and public utility enterprises, preferred stocks have been used for the purpose of enlisting capital from the public on what appear to be liberal terms, in such a manner that the control of the enterprise is held by an issue of common stock which stands for no investment. Preferred stock, issued under such conditions, is merely common stock with all the attendant risks and none of the advantages, since the holders of the so-called common stock have entire control, with no actual investment in the enterprise. The simplest case of this character is represented by a financial plan in which the tangible assets are exactly represented by preferred stock and the common stock is issued for control purposes only." (Pp. 47–48.)

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"* * * The managers, who may own only the common stock, become intoxicated with their success in a small way, and falsely assume that still greater success will follow the expansion of the business. They, being owners of the common stock, have everything to gain and nothing to lose; the preferred-stock holders, being limited in the amount of their dividends, have everything to lose through the failure of the expansion and nothing to gain through its success. It is for their advantage that the business should be small, compact, and able to resist depression and possible tightness of the money market; a big business adds nothing to their security, but it does jeopardize the maintenance of their dividends." (P. 58.)

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"Above all else it is essential that nothing in the preferred stock contract may be interpreted as giving the stockholders an actual lien on the corporate assets ahead of the notes and current obligations which it is proposed to negotiate in the future. All the other provisions of the preferred stock issue are innocuous 'safeguards' which help the sale of the stock among investors, without embarrassing the contemplated policy of corporate expansion on the one hand or giving real security to the stock on the other. Even the compulsory redemption of preferred stock referred to later, when adroitly worded by a corporation's counsel, can be interpreted as an intention rather than as an enforcible provision. They are the showy trappings of the advertising manager—mere trimmings." (Pp. 60–61.)

"One may hazard the supposition that the typical financial structure of the immediate future will be much simpler in form. The further extension of the intermediate securities—securities which attempt to combine the investment stability of bonds and the income increase possibilities of common stocks—is probably closed. Investors wish to know exactly the kind of thing they buy. They have come to realize, for a few years at least, that they cannot buy two things for the price of one. They cannot get both security and the opportunity for increase of income for the cost of security alone. If this is true, corporations, unable to find a market for the intermediate securities, will probably insist on a simpler financial structure. The characteristics, both the privileges and the limitations, of their bonds and their stocks will be more clearly defined. It is quite possible that common stock and common stock alone will again be found in the financial structures of all types of corporations; and it is quite possible that the bondholder will be given certain rights in the management of the corporation, such as the right to elect one or more directors or the right to exercise a controlling influence on the major plans of expansion. If that is done, the legal implications of the fundamental distinction between creditor and owner will be still further obliterated." (P. 67.)

the task becomes impossible, and the promoters have accomplished their purpose. Certainly a clear statement of how the money is supplied, and the profits divided, together with a simple, straightforward capital structure, is highly desirable.

"*Another danger, usually the result of greed, takes the form of a very large funded or floating debt or an excessive issue of preferred stocks.* Very often the managers and promoters receive their compensation and profit in the form of common stock for which they have paid little or nothing. There is nothing to criticize in this procedure if it is clearly and simply stated so that all can easily understand. As is pointed out in such cases, the management receives nothing until it has earned and paid some fixed percentage on the senior securities. In other words, the compensation is dependent upon the success of the enterprise. *But the difficulty is that the management or promoters have put up only a small percentage of the total funds. If the enterprise is a complete failure, they have little or nothing to lose.* It is natural, therefore, that they should take the attitude of 'Let's either win big or nothing.' This they accomplish by a very heavy pyramiding process. I do not believe that there are many people who with only $100 equity would, as a general practice, proceed to borrow and buy anywhere from $800 to $1,000 worth of securities, and yet that is exactly what many investment trusts are doing today.

"There is another difficulty to which pyramiding leads. With very heavy fixed charges and preferred dividends to meet, the management is under the constant necessity of producing a large dollar income the first and every succeeding year of operation with which to meet the relatively large fixed charges. This pressing necessity to produce immediate and constant income forces the investment of a large proportion of funds in securities of a less desirable type." [Italics supplied.]

It is true that in that article Mr. Cabot warns against "over-regulation" and states: "All that legislation should do is to require a degree of publicity that will enable any investor to form a sound opinion." The study compels the Commission to differ with Mr. Cabot on the effectiveness of mere publicity. In the first place, publicity will not help the investors whose contribution has already been secured for the types of capital structures so strongly condemned by Mr. Cabot. Secondly, the exposition by Mr. Cabot of the lack of sensitivity of the average public investor to the niceties of capital structure and the subtleties of the rights and privileges of security holders would appear to show clearly the ineffectiveness of mere publicity. To quote Mr. Cabot again from the same article:

"There are many investment-trust prospectuses in which it takes literally hours to figure just how profits are to be divided. To those not trained in finance the task becomes impossible, and the promoters have accomplished their purpose."

Paul C. Cabot in his testimony commenting on section 18 (d) of the investment-company bill cites the hypothetical example of a company formed with $5,000,000 of preferred stock and $5,000,000 of common stock which has paid preferred dividends regularly, but has had its assets reduced to $7,500,000. The preferred stock is fully covered but the equity of the common stock has been reduced to $2,500,000. The preferred stock is selling at a market discount, to wit, $80 per share.

At this point Mr. Cabot enters upon a number of suppositions, to wit:

1. The Commission will exercise its discretionary power of redistributing voting privileges.

2. The Commission will grant the preferred stock two-thirds of the entire voting power, and reduce the voting power of the common stock to one-third of the whole.

3. That the preferred stock, having received two-thirds of the voting power, will proceed to liquidate the company in order to realize its full $100 asset value which is $20 per share more than the current market value.

The result of these steps, Mr. Cabot argues, will be that the common stock will be compelled to take its asset value; and the loss sustained by that stock will be frozen against it with no chance of a come-back.

Mr. Cabot assumes for his suppositious case that the preferred stock has been originally granted a right of vote in the event of a default in dividend payments. It should be noted that only in rare instances has the preferred stock been given an effective voice in the management of the company even after default. Out of the 89 management-investment companies (of 160 companies examined) which had preferred stocks, only 4 companies provided that voting

control should pass to the preferred stock upon a certain period of delinquency in dividends. Twenty-six of the companies failed to grant any voting rights to the preferred on the passing of dividends. While the other 33 companies granted the preferred stock a right to vote on this contingency, the voting right granted was on the basis of a vote per share. Since the number of shares of common stock usually far outnumber the preferred shares, the voting rights granted the preferred stock were generally of small effect.

In Mr. Cabot's example, the shares probably would have been sold as follows: 50,000 shares of preferred stock at $100 a share for the $5,000,000 from senior security holders and 500,000 shares of common stock at $10 a share for $5,000,000 from the junior security holders. Although both classes of stock have made an equal capital contribution to the company, the common stock has 10 times as many votes as the preferred stock, even if the preferred stock has been granted a regular and permanent vote per share. Arguably the common stock is entitled to this voting supremacy because it has supplied a "cushion" of $5,000,000 to protect the preferred stock. However, it is equally arguable that when this "cushion" has vanished or substantially decreased, the reason for excessive voting power in the common stock also disappears. This argument is further supported by the fact that the common stock originally entrenched itself in the management of the company, and the disappearance of the cushion is thus attributable not to any activities of the preferred stockholders but primarily to the management by the common-stock holders. In such case an equitable redistribution of voting power may be needed to protect the preferred-stock holder. Section 18(d) of the proposed plan empowers the Commission to make this equitable distribution of voting power. What is equitable depends on the facts and circumstances of the particular case. This does not mean that the Commission may act arbitrarily. Its determination will be made only after a hearing in which all sides may be represented. Furthermore, an appeal to the courts from the Commission's decision is available.

Mr. Cabot arbitrarily assumes that the Commission would move in the particular instance for a redistribution and undertakes to decide in advance of a Commission decision what would constitute an equitable distribution of the voting power, namely a two-thirds voting power in the preferred-stock holders which will enable them to dissolve the company to the detriment of the common stock. Even so fundamental a type of redistribution as the allotment of voting power in accordance with the capital contributions made to the company by the various classes of shares, would mean that the preferred stock would acquire only fifty percent of the voting power—a quantum of votes equal to that of the common stock and insufficient to dissolve the company without the consent of the common-stock holders, since most State laws require a vote of the holders of two-thirds of the voting shares to effect a dissolution. Even such voting power might be allocated to the preferred stocks only until the asset value of the common stock had increased to its original value $5,000,000—or to such a sum as the Commission might determine to be fair to the preferred-stock holders. An alternative method might be to give the preferred-stock holders power to elect a minority or a majority of the board of directors until an adequate cushion of common-stock assets appeared. There is no basis whatsoever for assuming that power would be given the preferred stock to compel a dissolution of the company.

PRESERVATION OF CUSHION FOR SENIOR SECURITIES—SECTION 19 (B)

James H. Orr, president of the Railway and Light Securities Co., objects to the provisions of 19 (b) of the proposed bill. The study disclosed that it was a fairly common practice among investment companies to reduce the cushion upon which the senior security holders depended to a very slim margin by the payment of dividends to junior security holders. Subsequent losses could readily sweep away the narrow remaining margin and subject the senior securities to impairment of principal. In some instances dividends were paid out of contributed capital—the nominal, or official, capital having been reduced by a restatement of capital. In other instances payments of dividends on junior securities were made out of profits on portfolio security transactions (capital gains) in a period of rising market prices, with the result of injury to the senior securities with the advent of a period of less favorable market conditions.

The preservation of an adequate cushion is, of course, an indispensable condition for any sound bond investment.[16] The distribution of dividends to common stock or to a preferred stock which impairs the cushion of safety for the bonded indebtedness may be a real injury to the bondholders. A considerable number of indentures purport to accord a measure of protection of this nature by including a "touch-off" clause which requires the retention by the company of a certain margin of assets above the indebtedness.

Part Three, Chapter V of the Report shows that the cushion, which is thought to be preserved by the "touch-off" clause, is generally much too narrow and that these clauses are usually deficient by reason of ambiguity or unenforceablility. Occasionally some investment companies have voluntarily incorporated in their charters provisions specifically prohibiting dividends or other distributions to stockholders unless some fixed margin for senior security holders will exist after the distribution.

For example: Tri-Continental Corporation provided that no dividends should be declared upon the common stock unless at that time the net assets of the company equalled at least 200 percent of the aggregate amount to which all shares of the preferred stock were entitled in liquidation; American International Corporation provided that there should be no distribution upon the common stock if immediately thereafter the assets of the company amounted to less than 200 percent of all its funded debt. Such voluntary provisions are, of course, akin to the provisions of section 19 (b) of the proposed act.

Mr. Orr's objection to the provision of section 19 (b) appears to be based upon the fact that his company has paid preferred dividends regularly and dividends on the common stock since 1910, with the exception of 3 years; but that, in 28 out of the last 34 years, the asset coverage of the bonds has been between 200 and 300 percent; that is, within the area in which the S. E. C. is given discretion.

Mr. Orr appears to assume that at each prospective payment of a dividend to the preferred stock, when the coverage for the bonded indebtedness is between 200 and 300 percent, he would have to secure the consent of the Commission. It should be noted that the Commission may proceed by general rule and regulation—i. e., it may lower the required coverage to 200 or 250 percent for general application for a fixed period or until another rule or regulation is promulgated; or, for good cause shown, it may lower the coverage for a specific category of companies whose assets, policies, or voluntary protective safeguards are such that danger to the senior securities is not to be feared.

The witness does not deny that the cushion of safety for senior security holders should be protected. The Commission concedes that any absolutely inflexible margin would, by its very nature, be an arbitrary determination. That is the reason why it was thought necessary to allow for very wide flexibility in this connection. That the zones suggested in the proposed bill are not unreasonable is indicated by the fact that, in the great vicissitudes which the asset coverage of the bonds displayed in this company, the Act would disqualify the payment of dividends only in 1932 and 1933 and for the first quarter of 1938.

RESTRICTIONS AGAINST LONG-TERM BORROWING, SECTION (21C)

Objection has been raised to section 21 (c) which provides in part that after July 1, 1945, an investment company will be unable to renew or extend bonds or debentures maturing after that date.

The "introduction of leverage" by long-term borrowings was one of the practices of investment companies most severely criticized by investment-company sponsors and managers themselves at the public hearings.

Ernest B. Warriner, The Equity Corporation, testified:

"I would like to repeat also again, because I know that you are making these recommendations to Congress, that I do believe that all of my experience

"[16] Maintenance of adequate junior capital: We wish to call attention finally to a protective requirement for both bondholders and preferred stockholders which is technically of great importance, but which frequently is not taken care of in indentures or charter provisions. The point referred to is the maintenance of an adequate amount of junior capital. We have previously emphasized the principle that such junior capital is an indispensable condition for any sound fixed-value investment. No loan could prudently be made to a business at 5 or 6 percent interest unless the business were worth a considerable amount over and above the amount borrowed. This is elementary and well understood" (Graham and Dodd, Security Analysis, p. 224).

is that one of the greatest evils or dangers is the borrowing of bank money, which I have in my time that I was on the Boards endeavored to prevent, and that was borrowing of bank money for leverage purposes."

Frederick T. Hepburn, of the same corporation, stated that he was opposed to debentures because he thought that they did not fit into an investment company.

* * * * * * *

"Q. You think there was no debt mentioned——A. No; no debentures. You mentioned debentures. I would have opposed that. I don't believe it was mentioned——

"Q. I don't understand you.—A. I don't think there were any debentures mentioned, because I am sure I would have opposed it.

"Q. Why? Why would you have opposed it.—A. Well, I would have thought it was a definite obligation that did not fit this sort of operation."

Ralph W. Simonds, also of The Equity Corporation, testified:

"Q. Based on your experience with Yosemite Holding Corporation, do you think that a trust should borrow money from banks?—A. No, I don't."

Gare Dominick, National Bond and Share Corporation, testified:

"Q. Do you feel, for example, an investment trust should borrow money?—A. Again I am speaking personally. I dislike—I would dislike to manage a trust that is in the habit of borrowing money. * * *

"Q. Why would you in the future want to be certain to have cash in such transactions?—A. I don't think a trust of this kind needs to have the leverage of borrowed money. I don't believe they have to borrow money to make money, in most instances."

Lester Roth, National Securities Investment Co., testified:

"Q. The point I am discussing with you is, should they be permitted to borrow money?—A. I question it very much, as far as an investment trust is concerned.

* * * * * * *

"Q. Do you think under those circumstances that an investment trust ought to be permitted to trade on margin?—A. That is the same question you asked me, should they be permitted to borrow money, because it is immaterial whether they borrow from a broker or borrow from a bank. And I say that I doubt very much in the light of experience whether a trust should be permitted to borrow money."

Erwin Rankin, Founders Group, stated: "As far as borrowing from banks just to buy securities in the market, I don't think that should be done. That comes again on the question of leverage. I would rather see a company without any leverage."

Charles B. Stuart, Eastern Utilities Investing Corporation, testified: "I could only repeat what I said earlier in the day, that we just don't believe this type of company should ever put out a fixed interest-bearing obligation."

Harry M. Addinsell, of the same corporation, testified:

"And, of course, while we are on the subject, I have a very definite reservation in my mind as to whether things that are essentially, if you want to call this an investment-trust type, ought to borrow money from the public anyway. I don't believe I would want to handle such obligations now, because I think it is the sole, essential function of the management in the handling of an investment trust, and I think that the risk is more of a stock risk than it is a promise-to-pay risk, and I also think that it is almost impossible especially if you have a very large portfolio as distinguished from the theoretical idea of a call loan at a bank, to exercise your remedies, even though you have need to, because of the quantity involved and the fact that when you arrive at that kind of situation where you have to do something it is probably impossible as a practical matter to do it, in other words, to exercise it."

* * * * * * *

"Q. Do you think the opinion of the investment bankers is substantially in agreement with yours that their influence will be sufficient to prevent the issuance of definite obligations by investment trusts?—A. I don't know the answer to that. I haven't discussed it with enough people to know what their point of view is."

Philip J. Roosevelt, of Investment Trust Funds A, B, and C, testified: "They should not borrow money, for if they do, they are in effect, operating a margin account for their investors which we believe means taking an unwarranted risk for their account. Stocks have sufficient volatility without any added leverage."

The sponsors of some of the largest investment companies testified to the extremely demoralizing effect of debenture capitalization and bank borrowings upon the policy and economic welfare of the companies.

Louis H. Seagrave, of the Founders Group, stated: "* * * there isn't a question in my mind but what excessive borrowing and excessive preferred stock are the virtual ruination that contributed more than any other factor to the difficulties of our group of companies. Therefore, I should say that if preferred stock or borrowing are to be permitted, there should be some restriction in the amount, either in the assets of the company, because that is done by the companies themselves, or by law. I think that is about the sum of it on that point."

Erwin Rankin, of the same group of investment companies, indicated why borrowings were so dangerous to investment companies: "For instance, when an investment company has a bond on which they have to pay 5 percent and pay 6 percent on the preferred, let us say the over-all is a 5 percent requirement on its capital, that company can't very well afford to be buying bonds that yield 3 to 4 percent.

* * * * * * *

"It became clearly apparent in the type of decline that we had after 1929 that any single investment company couldn't exist with a large part of its capital in bonds and preferred stock just as a single company alone and when you have it as in the American Founders group with not only your subsidiaries, but with other companies on top of them, it became rather clearly apparent."

George D. Woods, Eastern Utilities Investing Corporation, testified:

"Q. What reasons do you have for your opinion that investing companies should not be in debt?—A. My conception of these investment companies is that they are primarily for the purpose of small investors who want to have the protection of some diversification as far as type of investment and location of investment is concerned, but do not have enough money to enable them to make investments in units which would bring about such diversification.

* * * * * * *

"I fail to see why, having made such an investment for those purposes, there should be any prior obligations. My feeling is that these investment companies should gradually get into the category of the good fire insurance companies and casualty companies where if they have a preferred stock or if they have made a loan people immediately look askance at them, on the theory the good ones never have anything except common stock."

Under section 21 (c), outstanding bonds, debentures, or bank borrowings are not in any way affected. An existing obligation of this sort may be renewed or extended any time before July 1, 1945. All the existing obligations need not be liquidated until their maturity—whatever the date may be—and the companies have a period of 5 years within which to renew or extend these obligations to some future date, if necessary. The only limitation upon companies with existing indebtedness is that, if they do not choose before July 1, 1945, to renew or extend existing obligations, they will not be in a position after that date to embark upon a policy of renewed borrowings.

DEBENTURES IN AFFILIATED FUND, INC., AN OPEN-END COMPANY

John Sherman Myers, vice president of Affiliated Fund, Inc., and Andrew J. Lord, president of that company, objected to the prohibition of section 18 upon the issuance of additional debentures and the provision in section 19 (b) to the effect that no dividends may be paid to common stock unless outstanding debentures have an asset coverage of 300 percent. That section authorizes the Securities and Exchange Commission to raise the minimum coverage requirement to 400 percent or lower it to 200 percent.

Affiliated Fund, Inc., is an investment company of a somewhat unusual structure in that it is an open-end company—i. e., any stockholder may require at any time that he be given the approximate asset value of his shares on the surrender of the same; and yet has a senior security outstanding, to wit—two issues of debentures. Affiliated Fund, Inc., is the only open-end investment company of substantial size to have debenture capital in its structure. All other large open-end investment companies issue only common stock.

Mr. Lord explains very frankly the practical difficulties which the provisions to which he objects may put him. He states that the principal business of

Lord. Abbett & Co., the sponsor of Affiliated Fund, Inc., is the distribution of investment-trust securities—mainly the debentures and common shares of Affiliated Fund, Inc.—and that "the bill as drawn prohibits us from the future sales of debentures." Mr. Lord suggests the fear that the sale of the common stock of Affiliated Fund, Inc., also, will be terminated because investors will not buy common stock upon which dividends cannot be paid in the absence of a 300 percent coverage for the debentures; and the debentures of Affiliated Fund, Inc. are not covered to that extent. To the inquiry of a member of the subcommittee as to whether Affiliated Fund, Inc. could not liquidate the debentures and issue only common stock, Mr. Lord replied that his company would then be no different in capital structure from several other large and successful open-end "mutual companies," better established and with better records than Affiliated Fund, Inc.; and that, without the attractive characteristics of leverage, he would find it difficult to sell Affiliated Fund, Inc. common stock in competition with these companies.

It is, of course, regrettable that, in seeking to place the investment industry on an economically sounder foundation and to make its administration more responsive to the expectations and needs of the small investor, legislation should create practical problems for sponsors of investment companies. It cannot, however, be seriously contended that such features of capital structure and such practices as long-term borrowing, which have proved themselves a menace to the investor, should be preserved because they are helpful to sponsors in merchandising investment-company securities. Mr. Lord testified that the present coverage of the debentures in Affiliated Fund, Inc. was approximately 240 percent. Perhaps the "rubber" in the proposed bill, which Mr. Myers severely criticized, may come to the aid of Affiliated Fund, Inc. The Commission might perhaps find—in view of the unusual safeguards with which the charter and trust indenture have voluntarily surrounded the debentures, such as the yield index and the redemption privilege of the debentures—that the payment of dividends to common stock with a 200 percent debenture coverage would not constitute an injury to the debenture holders.

It appears from the testimony of Mr. Myers and Mr. Lord that the continuous marketing of investment company securities, either debentures or common stock, is a primary objective of Lord, Abbett & Co., Inc., and that the common stock of the leverage company sponsored by it has not performed nearly as well as the common stock of the "mutual" open-end companies. The continued issuance of both debentures and common stock is apparently the objective of Affiliated Fund, Inc., as "leverage" is the particular feature of this open-end company which it can profitably publicize in its sales efforts. But it is this very element of "leverage" which exposes the common stock to such dangers and hazards as to make it unsuitable as an investment vehicle for the small investor.

The witnesses representing Affiliated Fund, Inc., point to safeguards in behalf of the debentures to distinguish that company from other leverage companies. Nevertheless, major intrinsic defects of the leverage structure, heretofore pointed out, are to be found in Affiliated Fund, Inc.

As in the vast majority of leverage companies, the rate of the net regular income of Affiliated Fund, Inc., has been lower than the cost of hire of the senior capital. The ratios of net regular income to average assets for the last three years have been: 1937, 2.99 percent; 1938, 1.39 percent; and 1939, 2.66 percent. The ratio of interest payable on the debentures until October 19, 1939, was 5 percent on a $6,000,000 issue and 4½ percent on a $2,000,000 issue. On October 19, 1939, the 5-percent issue was refunded by a 4-percent issue and on January 31, 1940, an additional $1,761,000 of 4-percent debentures was issued, bringing the total debentures to $10,000,000, consisting of $8,000,000, on which 4 percent interest is payable and $2,000,000 on which 4½ percent interest is payable.

Mr. Lord urges that "many important corporations employ senior capital for the benefit of the equity holder." That, of course, visualizes the case of industrial companies which cause the borrowed capital to produce a higher rate of return than the cost of the borrowed capital. In Affiliated Fund, Inc., as in other leverage investment companies, the common-stock capital has to be put to work to make up the deficit in earning capacity of the borrowed capital.[16]

[16] It has been shown in the hearings before the committee that many leverage investment companies have failed to earn the amount of fixed charges by the use of the entire fund, both the senior and junior capital.

Under such circumstances it would be fairer to say that investment companies are compelled to employ their equity capital for the maintenance of the senior securities. In other words, the common-stock holder of the leverage company must yield part or all of the earnings on his contribution to capital to pay the prior charges on the senior securities.

The witnesses representing Affiliated Fund, Inc., conceded that that company had to borrow from paid-in surplus in order to pay a 6-cent quarterly dividend on the common stock in July 1939. The amount borrowed from paid-in surplus was restored by the end of the year by realized capital gains. A member of the Committee summed up the situation in the statement: "If you guess right, it's all right, of course."

The lack of investment quality characterizes the common stock of open-end leverage investment companies as well as that of closed-end leverage investment companies. The contributor to the open-end fund can easily be impressed by the representation that the senior capital is working for him; he can less easily be expected to realize that most of the time his capital is sustaining the senior charges and that upon any substantial market oscillation his investment will be vitally impaired or entirely swept away.

Mr. L. M. C. Smith. I should like to point out to you a fact that we had not emphasized: That all these exchanges Mr. Schenker spoke of are primarily related to senior security companies. Everywhere you move you get into conflicts when you get into senior securities. You have many conflicts of interest. Even when you get down to the situation of no more than a third of senior securities which Senator Taft suggested, the same conflicts exist. You have to take care of your voting rights, the further issuance of senior securities and you have to enlarge all your dividend protective provisions. Soon you will have something that is comparable to the 10 or 15 or 20 pages that they write when they have a preferred stock indenture or, provisions in the charter.

Senator Hughes. In submitting these long statements for the record, I think we had better reserve the right to place in the record what we think should go in—at some meeting when we have more members present.

Mr. Schenker. Senator, just two things: There were quotations, by some members of the industry, from the Christian Science Monitor. We should like to introduce an editorial which appeared in that paper with respect to the investment trust bill.

(The editorial from the Christian Science Monitor, Boston, Mass., dated March 20, 1940, is as follows:)

An Investment Trust Bill

The coming hearings on the Wagner-Lea bill for regulation of investment trusts should prove a workshop for the hammering out of a highly useful regulatory law. It is not to the point to say that regulation of investment trusts now is merely locking the door after the horse wandered away. Not only are new kinds of investment trusts constantly being invented and sold to the public, but another cycle might produce something like the growth of investment trusts with assets of $7,000,000,000 in the twenties which subsequently shrunk to $3,000,000,000. Progressive investment trust managers have no quarrel with the establishment of legislative standards which will prevent less scrupulous persons from capitalizing on the record of the better-run trusts.

The Securities and Exchange Commission has made a thorough preliminary investigation, taking over 4 years, during which the problem itself was in process of change. It has refrained, in the bill before Congress, from repeating the "death sentence" imposed on the utility holding companies. It has consulted with the investment trust leaders before sumbitting its bill, and is making no effort to high-pressure the bill through Congress.

There will therefore be proper time allowed for consideration of the bill. It should be examined not only to see that investors will be protected, but also to make sure that the burden of new rules and regulations imposed on invest-

ment trusts is not excessive. The bill should be scrutinized to see that dangerous discretionary powers are not granted to the Securities and Exchange Commission, and that the drafters have not capitalized on the misfortunes of the early thirties to introduce punitive legislation into the bill in the guise of preventive measures.

Mr. SCHENKER. I should also like to have introduced into the record an editorial that appeared on April 17, 1940—that is, after these hearings were started. I think you might like this, Senator. This is from the Springfield (Mass.) Republican; and I just want to read two sentences, to show the way in which it begins (reading):

If it is the last thing it ever does in the direction of reform, the New Deal should bring investment trusts under Federal regulation. For the night is coming. It seems remarkable that definite action has been so long delayed, in view of the scandalous history of so many of the buccaneer trusts in the period that culminated in the collapse of speculation a decade ago.

The Securities and Exchange Commission, however, was first created and its exhaustive reports concerning investment trusts, or companies, of various types, have been slow in reaching Congress. Based on them is the Wagner bill for the regulation of the trusts, which is now the subject of hearings before the Senate banking and currency committee.

Then it goes on to discuss our reports and to discuss the nature of the bill; and as I read this editorial, it says it is a very moderate bill. Then it goes on to conclude as follows:

The Wagner bill, as has been said, seeks to give the small investor in trust shares a minimum of protection. To that end the bill reasonably requires that an investment company keep its shareholders fully informed as to its investment policies; that the company's size have maximum limits; that the salaries of managers be given full publicity; that there be periodical reports; that the Securities and Exchange Commission prescribe uniform accounting and auditing methods and examine the company's books.

A bill substantially along these lines ought to become law at the present session.

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The Securities and Exchange Commission, however, was first created and its exhaustive reports concerning investment trusts, or companies, of various types, have been slow in reaching Congress. Based on them is the Wagner bill for the regulation of the trusts, which is now the subject of hearings before the Senate Banking and Currency Committee. Critics and opponents of the bill are being patiently heard. Some of them, like one trust executive from New York City, tells the committee that investment companies might "better go out of business" than attempt to operate under the regulation proposed.

Perhaps that would be the best solution, if no middle ground of regulation can be found. The investment trust, or company, is a comparatively new piece of machinery in the field of private investment. The flow of private investment capital went on substantially without its aid until after the World War. But nothing drastic, nothing killing, is embodied in the Wagner bill. It is even so moderate that its chief reforms would apply only to trusts hereafter organized. The worst abuses are doubtless in the past; yet some of them, according to the Securities and Exchange Commission, date since 1933. That they require looking after is seen in the fact that since 1933, also, nearly 2½ billions of capital investment-company issues have been registered with the Securities and Exchange Commission, indicating that the going is not so bad even in these times.

The Wagner bill is based on the proper theory that the investment trust is intended to serve the small investor, who has neither the opportunities nor

the special knowledge nor the capital necessary to make him expert in investing his savings in the securities market. Actually many of these trusts have been managed for the enrichment of their sponsors and managers, who have often prospered on rascality while their stockholders have gone broke.

The Wagner bill, as has been said, seeks to give the small investor in trust shares a minimum of protection. To that end the bill reasonably requires that an investment company keep its shareholders fully informed as to its investment policies; that the company's size have maximum limits; that the salaries of managers be given full publicity; that there be periodical reports; that the Securities and Exchange Commission prescribe uniform accounting and auditing methods and examine the company's books.

A bill substantially along these lines ought to become law at the present session.

Mr. SCHENKER. I just want to add one word, Senator: I have been in rather close contact with this whole investment company situation, and I think if there is going to be legislation, it ought to be done pretty expeditiously because, in my opinion—and I do not want to appear to be a Calamity Jane—if you do not have legislation, you are going to have difficulty. Our study is over. We can no longer even ask a person to come down and talk to us. With the state of securities selling at discount, I honestly feel that there is going to be difficulty, and I honestly feel that the industry may be injured without regulation. That is why we feel the legislation ought to be passed this session.

Senator HUGHES (presiding). Has the Commission closed?

Mr. HEALY. Yes.

Mr. SCHENKER. Yes; I am through.

Senator HUGHES (presiding). Of course, you are allowed the right to introduce such statements as you may see fit by, we shall say, Tuesday.

Mr. HEALY. No, Senator; Mr. Schenker has finished, but I want to say something; and then Mr. Hollands wants to say something; and then we shall conclude our presentation very briefly.

Senator HUGHES (presiding). However, I shall make that statement now: That until Tuesday of next week, anyone having a statement that is reasonably admissible into the record will be permitted to submit it. Of course, we cannot let these statements occupy an indefinite amount of space, as you all understand. However, with that limitation, up until next Tuesday we shall receive any such statements; and that privilege is extended to all parties.

FURTHER STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. HEALY. May I proceed, Senator?

Senator HUGHES (presiding). Yes, certainly.

Mr. HEALY. I want to say a few words on the subject of the provisions of the act giving the Commission the power to bring about an equitable redistribution of voting rights. It is stated that that is somewhat a novel proposition and proposal—and it is. It is not completely novel, because a provision almost exactly like it is in the Holding Company Act of 1935, on which the present pending provision is modeled.

I do not for a minute believe that we should have a statute here which permits anybody to turn the voting control of a corporation over to the preferred-stock holders merely because the preferred stock

happens at a particular moment to be under water, or merely because the dividends have been passed, let us say, for one period or for a year.

On the other hand, I should like to call the committee's attention to this kind of a situation: You have corporations which have no debt; there is no default in debt or in the payment of interest, and therefore the company cannot be put into bankruptcy or into reorganization under the Chandler Act—the successor of 77B. Yet in those cases the preferred stock has not had a dividend for 5, 6, 7, or 8 years, and the preferred-stock holder is completely helpless. The common stock, which has no actual value, is in complete control of the situation; and the preferred-stock holder, in that predicament, is probably the most completely helpless type of security holder that there is in the United States.

Now, again I will make no plea for the language that is in the bill in this respect. If this language is not satisfactory, then I should like to suggest that the committee consider a provision of some such character as this: That after dividends have been in arrears for a certain length of time, the preferred-stock holders, voting as a class, can elect X percentage of the board of directors. If the dividends have been in arrears or are in arrears for an additional period of X years, then the preferred-stock holders should be given the right to elect a majority of the board of directors.

You might have a comparable provision wherein the preferred stock has been under water for a stated length of time. You might put an additional safeguard by providing that the control of the board of directors should not be turned over while the common stock can demonstrate that there is a fair chance or a reasonable chance that the dividends can be resumed and the arrearages cured.

In that connection I should like to comment upon the statement made by some witness whose name I do not now recall.

Senator Hughes. To whom are they to demonstate that?

Mr. Healy. That could be demonstrated to the Commission according to a standard written into the act, with the right of court review.

Senator Hughes. Yes.

Mr. Healy. The expression on which I should like to comment and the evidence with respect to which I should like to speak was something to this effect—I do not remember who said it, but some witness appearing for the industry said that the words "fair and equitable," appearing in this statute in connection with reorganizations, constitute an indefinite standard. I should like to point out that in a long line of cases decided by the Supreme Court of the United States, culminating in the *Los Angeles Lumber case*, the Court has held that the words "fair and equitable," as used in the Chandler Act and as used in equity reorganizations before 77B, were words of art and had a definite legal meaning, and that definite legal meaning was surveyed and stated in the *Los Angeles case;* and if we have got anywhere in this act words whose definite legal meaning is established by a long line of judicial decisions, they are those words "fair and equitable."

Mr. Healy. Senator, Mr. Hollands would like to say a few words at this time.

Senator Hughes (presiding). Very well. Please proceed, Mr. Hollands.

FURTHER STATEMENT OF JOHN H. HOLLANDS, ATTORNEY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. HOLLANDS. Senator, I should like to take about 1 or 2 minutes to speak about section 36 (a). That section reads as follows:

SEC. 36 (a). The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as it finds necessary or appropriate to carry out the provisions of this title, including rules and regulations defining—

And so forth. The rest of the subsection enumerates certain specific matters.

A good deal of the testimony presented by representatives of the industry has given the impression that the bill consists of an itemization of problems, with a provision for rules, regulations, and orders tied to its tail.

I think that, upon examination of the bill, it will be found to be much more discriminating in choosing the subjects with respect to which so-called administrative discretion is granted and with respect to which it is not.

The high point of the industry's testimony in regard to the subject of discretion has largely centered around section 36 (a). Mr. Bellamy, who is associated with National Bond & Share Corporation, introduced into the record a few days ago a copy of a letter which his company sent to its stockholders. In analyzing the bill in that letter, there appears the following statement, after a sentence running six or seven lines, which describes various specific matters dealt with in the bill. The sentence to which I have referred reads as follows:

In addition and over and above all, the bill provides that the Securities and Exchange Commission from time to time may prescribe such rules and regulations within the provisions of the bill as the Commission may deem necessary or appropriate. In other words, in addition to its specific provisions, the bill vests in the Securities and Exchange Commission a continuing supervision not only of the management of investment companies but of substantially every phase of activity in which such companies may engage.

I do not want to go into a detailed discussion of what the words in section 36 (a) mean. It seems to me that the words of the section are fairly clear.

What is more important, I believe, is that substantially identical provisions appear in section 19 (a) of the Securities Act of 1933, section 23 (a) of the Securities Exchange Act of 1934, section 20 (a) of the Public Utility Holding Company Act of 1935, and section 319 (a) of the Trust Indenture Act of 1939.

The Trust Indenture Act was before this committee at the last session of Congress.

In the committee reports, this committee pointed out that in that bill—which I may say, parenthetically, deals with a very different problem from the problem we have here—an attempt had been made to cut down administrative discretion to the absolute practical minimum; yet that bill contains a provision that is virtually identical with section 36 (a) of this bill.

What is more, when the trust-indenture bill reached the House, the Interstate and Foreign Commerce Committee apparently determined to cut down still further what little administrative discretion there was in the bill, and the report of the Interstate and Foreign Commerce

Committee states that they had absolutely eliminated administrative discretion; yet, the Trust Indenture Act contains a provision that is virtually identical with section 36 (a).

In other words, as Judge Healy said when we were presenting our affirmative case, and as Mr. White, I believe, noted in his testimony—though in a somewhat skeptical tone—this section does not give substantive powers; it is there for purely procedural purposes, to implement the other provisions that are in the bill.

May I give the citations for those references to the committee reports? Senate Report 248, page 2; House Report No. 1016, page 30—both of the Seventy-sixth Congress, first session.

Thank you.

FURTHER STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Healy. Now, Senator, with your permission, I should like to resume.

Senator Hughes (presiding). Very well, Mr. Healy.

Mr. Healy. Senators, this is the last speech that you will hear from anyone representing the Securities and Exchange Commission on the subject of this bill. There are two or three things left about which I should like to speak.

First, I should like to say that the principal reason why the bill is as complicated as it is is due to the fact that it is to a large extent a series of compromises on various topics where, instead of—for example—having a complete segregation of investment bankers or commercial bankers or brokers, an attempt was made to permit it and then to circumscribe it. Compromises of that character necessarily led to complicated provisions.

The second point that I wish to make arises in connection with some statements that have been made regarding the time taken in the investigation. I had the interesting experience, once, of appearing before either this committee or the House Committee on Interstate and Foreign Commerce, in connection with the Holding Company Act, where the Federal Trade Commission had conducted an investigation of holding companies, and the investigation had lasted practically 6 years; and I heard the industry's representatives stand up before the committee and say that no bill ought to be passed until there had been a thorough investigation of the holding-company problem.

I believe that these investigations have to be thorough in order to meet the expert ability of the people in the industry and in order to satisfy the committees of Congress.

In that same connection I should like to point out, in fairness to my associate, Mr. Schenker, that whereas at the beginning of this study he was given one job to do, after Dr. Gourrich resigned—Dr. Gourrich had been in charge of the study and had formerly been head of the research department of Kuhn, Loeb & Co. for many years, and was an outstanding man in that line—and after we had the misfortune to lose Bill Spratt, through death, Mr. Schenker had the task of doing three jobs instead of one, including the writing of this final report.

I should like to refer as briefly as possible to this matter of discretion. When I listened to some of the statements made here, I thought for a moment that I was hearing people say that there ought to be flexibility in this bill and that there ought to be no discretion lodged with the Commission. Of course, that is an impossibility. However, upon rereading some of the testimony, I realized that that was not the fact. I am speaking from memory, so far as Mr. Quinn's testimony is concerned; but my memory is that he said there should be no discretion in the Commission except in accordance with well-settled and well-written, clearly-defined statutory standards.

If I am wrong about that, I hope Mr. Quinn will correct me.

I agree completely with that position. I should like to repeat what I said before: That undefined and unfettered discretion is not consistent with the American principle of the supremacy of law; and, furthermore, if you gave it to us, it would not be any good, because it would be invalid.

The statement has been made here that just as little discretion as possible should be permitted to the Commission. With that I am in complete accord. So cut it down as much as possible without destroying flexibility, if you please; and then define the standards so that this Commission will not be in the position of trying to write law, but simply to implement and mechanize the law that has already been made by Congress.

Anything different from that would be completely undemocratic; it would be as completely undemocratic as some of the trusts that we have heard described here, where the people who own the trusts have absolutely no power whatever in connection with voting or directing the affairs of the trust; it would be as completely undemocratic as Mr. Trotsky, one of the founders of communism, and one of whose statements, strange to say, was quoted with evident approval here before this committee by a conservative Boston banker. That was a unique experience in my life.

Yet I venture to say that the sort of bureau that Trotsky was talking about was a bureau outside of law, not a bureau that was administering a law fixed by Congress; and I venture to say also that no bureau ever established by that author that Mr. Griswold seems to admire so much, was ever as undemocratic as that type of trust in which the shareholders and owners have no vote and no voice whatever in the management.

If you want to take section 36 (a) and make it perfectly plain that it does not give us substantive rights—we have never claimed substantive rights, under precisely the same provisions of other acts—and that its merely to implement the law and for procedural purposes, you will get no complaint from us. We will go along with it, all right.

Now just one or two other short observations, and I shall be through: I have had the fortune—or misfortune—of seeing a major Federal investigation that involved about twice as much capital contribution as this did, and I have seen something of other investigations. I do not recall any investigation that was conducted, where there was more cooperation from the industry, and which ended with less acrimony between the industry and the Government, than in this instance. I have heard very little criticism of the method of conducting the study.

To be sure, attack was made upon the statistical report; but as I stated this morning, statistics always seem to be attacked; and any exchanges that have gone on across the table, here, during the course of this hearing, I think are simply the result of the normal reactions of human nature under strain and when people are on opposite sides, acting as advocates to some extent in making the best case they can.

I have heard but one witness, out of all those who appeared here, who went on the witness stand and said that there should be no regulation.

So that despite whatever complications and stresses may have developed during these hearings, I think they have been rather unique in the respect that nearly everybody has agreed on the need of regulation, and very little criticism—outside of the statistical phase—has developed on the subject of the method of the study.

That is about all that I have to say.

Again I want to acknowledge the gratitude of the Commission to the industry, for their cooperation. I should like to say that if in the heat of these debates we have overstated anything or misstated anything—some of the speeches were made extemporaneously and from memory—if they are called to our attention, we shall make every effort to correct them.

Then, last and most of all, I think we are all indebted to the committee for its very courteous attention during the presentation that must at times have been somewhat monotonous. We are very grateful to you.

Senator Hughes (presiding). I might say that as a member of this committee I have not heard all the investigations that have heretofore been made, but I did sit as a member of the subcommittee on the Barkley bill and on the Maloney bill, and I have had some experience with this sort of evidence before a committee. It seems to me that it has been signalized by unusual forbearance and courtesy and good feeling; and we are very much obliged to you for presenting it in that way.

We thank the Commission, and part with it with deep regret—although we realize that in the course of the years we shall probably cross each other's path again.

Senator Hughes (presiding). Mr. Bunker, I think we shall hear from you at this time, if that is convenient.

Mr. Bunker. Thank you, Senator. That is very nice of you.

FURTHER STATEMENT OF ARTHUR H. BUNKER, EXECUTIVE VICE PRESIDENT, LEHMAN CORPORATION, NEW YORK CITY

Mr. Bunker. I have asked for the privilege of appearing once more before you, in order to submit briefly certain constructive proposals with respect to this bill.

Before doing so, however, I feel that I must say one word about the criticism which representatives of the S. E. C. have in the past few days directed at the previous testimony of myself, Mr. Traylor, and other members of the industry.

First, I wish to state to you that I reaffirm in all respects the color of the testimony which I have previously presented. In order that the record may be straight, I should like to file within the next few days statements in refutation of some of this criticism.

Mr. Traylor and others have asked me to say that they also stand by their testimony, and likewise wish to file statements.

Senator HUGHES. I made the statement that you would be permitted to do so.

Mr. BUNKER. I appreciate that, Senator. I wondered if there was any chance of extending the period. There has been such a mass of matters presented in the last three days that, frankly, with just Saturday and Sunday in which to prepare it——

Senator HUGHES. We will give you ample time. We will give you until Friday.

Mr. BUNKER. That would be very much appreciated indeed. Any time during Friday?

Senator HUGHES. Yes.

Mr. BUNKER. That will be very much appreciated.

Senator HUGHES. It will take us that long at least to read the testimony.

Mr. BUNKER. You will not catch up to us, I think.

A considerable number of the gentlemen who have appeared before you—in both the open-end and closed-end sections of the investment company industry—have done me the honor of asking me to present to this committee a statement of their joint views.

At the outset of these hearings, speaking on behalf of a committee of investment companies, I declared ourselves to be in favor of reasonable Federal regulation of our industry. During the course of these long hearings, various leading members of both sections of this business have outlined to this committee their views as to the proper scope of regulation of investment companies, as well as their objections to certain portions of the bill before you. Most of us have presented to you sets of broad principles upon which, in our opinion, regulatory legislation should be based.

Senator Wagner has indicated upon several occasions that it would be helpful to the Committee if these general suggestions could be translated into specific recommendations applying directly to the bill in hand.

We are very anxious indeed as these hearings close to put the stamp of sincerity upon our initially expressed desire for regulation. Therefore, representatives of a substantial proportion of our industry—both open-end and closed-end—have held a number of conferences in the past few days, and have correlated and combined our various individual suggestions into a specific set of practical proposals, within the framework of the bill before you. We are submitting to you today this outline, which is as precise and complete as time has permitted us to make. I am sure you will appreciate that there has been no chance to devise detailed language but only to state general provisions, which, however, we believe are definite enough to leave no doubt as to their meaning.

While there has been insufficient time to consult all members of our industry, our proposals, as I have said, embody the considered and agreed views of a large and, we think, representative portion of it.

The proposals which we are making to you will, in our opinion, take care of most of the abuses which have been discussed at these hearings. In fact, I think I can say that they will take care of all of the abuses insofar as any reasonable legislation can do so.

Specifically, these provisions cover the subjects of independent directors; overnight changes in management; dumping of securities

by interested parties, and self-dealing; changes of fundamental policies which are to be prohibited without stockholders' approval; abuses in the distribution of investment company securities, including dilution of the equity of existing stockholders; full publicity and disclosure to stockholders in periodic reports; proper advices as to source of dividends; proxy control; the establishment of accounting standards; and provisions for complete audits.

All of these will be accomplished in a simple manner with administrative discretion reduced to that minimum required for flexibility. Certainty takes the place of uncertainty in the bill now before you. Our proposals do not attempt the impossible. They are not so drastic and so complex that they can be made workable only by vast delegations of power. They do not attempt to cure all possible defects of State corporate laws—defects which, if they exist, apply equally to all corporations and not merely to investment companies.

We do not guarantee that these proposals are a complete cure-all, or that when tested by experience it may not develop that some amendments may be desirable. But we do say that they constitute a basis for workable legislation, that they accomplish the main objectives of the bill now before you, and that legislation embodying them would receive our support. Under such regulations we are certain that the industry could live and better serve the interests of its stockholders and of the public.

We hope that our suggestions may permit the realization in workable form of the objective of this committee, namely, to bring about at the earliest practicable moment adequate and livable regulations. Should, as we hope, our suggestions agree with your opinions in this matter, those elements of the industry for which I am now speaking are prepared to cooperate with your committee in any way which you may indicate, not only in drafting such amendments to the present bill as may be appropriate, but also in endeavoring to bring into agreement those members of our industry who would be affected by the legislation, and to whom we have not yet communicated these suggestions.

The framework of the proposed investment company bill, Title I, is as follows:

1. With reference to Findings and Declaration of Policy, Sections 1 and 2 of the present bill: These should be revised to accord with the revision of the bill. We earnestly hope that the report of your committee will call attention to the tax problem and to the desirability of providing special tax treatment not merely for certain classes of open-end investment companies as under the present tax law, but for closed-end investment companies as well.

2. Definition of Investment Companies, now Section 3 of the present bill: These definitions are in the main satisfactory, but careful consideration should be given by the draftsman to make certain that there are eliminated those companies whose inclusion under the present bill was neither intended nor desired. As in the present bill, power should be lodged in the Commission upon application to determine that a company is not an investment company, where such is the case, even if it falls within the scope of the technical definition.

3. Classification of investment companies, now section 4 of the present bill: The classifications in the present bill are satisfactory. Later the question will be raised of treating face amount certificate

companies, unit investment trusts, and periodic payment plan companies under a separate title.

4. Subclassification of management investment companies, now section 5 of the present bill: The division of management investment companies into "open-end" and "closed-end" companies is satisfactory. The further subclassifications of this section are neither logical nor sound, and should be revised to provide for only two types of companies perhaps known as diversified investment companies and securities finance or holding companies.

(*a*) A diversified investment company should be defined as a company which as to at least 75 percent of its total assets holds no security of any one company in an amount greater than 5 percent of its total assets and not more than 10 percent of the voting securities of any one company.

(*b*) A securities finance or holding company should constitute any management investment company not falling within the requirements of a diversified investment company.

5. Exemptions, section 6 of the present bill: We believe the present provisions of the bill to be satisfactory substantially in their present form, including the powers delegated to the Commission.

6. Transactions by unregistered investment companies, section 7 of the present bill: The provisions of the bill constituting a ban on transactions of unregistered companies are satisfactory in substance as a means of enforcement of the provisions of the bill. We question, however, the desirability of precluding the registration of foreign investment companies.

Senator HUGHES. You would include foreign investment companies?

Mr. BUNKER. We question the desirability of precluding the registration of foreign investment companies.

Senator HUGHES. Then you think they should be included?

Mr. BUNKER. That is right.

7. Registration of investment companies, section 8 of the present bill: Our suggestion would be that the provision for registration conform with similar provisions of the Securities and Exchange Act of 1934 including equivalent powers to the Commission.

In addition the registration statement should contain a declaration of the fundamental policy of the investment company in respect of the following items:

(*a*) Classification in which the company proposes to operate;

(*b*) Policy as to borrowing;

(*c*) Policy as to issuance of senior securities;

(*d*) Policy as to underwriting;

(*e*) Policy as to concentration of investment in any particular industry or group of industries.

8. Prohibition on certain persons acting as officers or directors, section 9 of the present bill: In lieu of the provision for the registration of officers and directors, provide for a flat prohibition of any person acting as such who has within the past 10 years been convicted of a felony or misdemeanor involving the purchase or sale of any security or is under injunction by court from acting in certain capacities as specified in the present bill. However, power should be given to the Commission in its discretion to grant exemptions from this prohibition.

9. Affiliations of directors, section 10 of the present bill: In lieu of the elaborate and complicated provisions of section 10 of the bill, provide that the board of directors of any investment company shall include a minimum percentage (40 percent) of directors who are independent of principal underwriters, regular brokers, managers or investment advisers.

This requirement for independent representation, plus the prohibition on self-dealing later referred to, should remove possibilities of abuse without stripping investment companies of competent and experienced directors.

10. Certain prohibitions, section 12 of the present bill: Margin purchases and joint trading accounts should be prohibited and also short selling in contravention of rules and regulations of the Commission. Underwriting commitments of diversified investment companies should be limited to a maximum of 25 percent of total assets and should, of course, be permitted only to such companies who have in their registration statement declared that they proposed to underwrite. In respect of underwriting, provision should also be made for carrying on underwriting and related activities through subsidiaries or companies to be owned by more than one investment company.

In the future no investment company should be permitted to exceed the 5 percent and 10 percent rule advocated for diversified companies in acquiring the stock of another investment company. This will put an end to pyramiding. Proper exception, however, should be made in connection with transactions designed to simplify existing investment company systems and in connection with reorganizations, mergers, and so forth.

11. Changes in investment policy, section 13 of the present bill: With classification and investment policy provided for, there should be a prohibition against any change in classification or in fundamental investment policy as announced in the registration statement without stockholders' consent.

12. Compensation of management, management and underwriting contracts, section 15 of the present bill: This provision should contain substantially the same requirements for approval by stockholders and prohibition on transfer of management contracts without consent of shareholders. It should not, however, dictate the basis of management compensation, provided that the method of payment is clearly and adequately set forth to shareholders. Underwriting contracts should also be covered substantially as in the present bill. It would seem advisable that existing rights under outstanding contracts be left undisturbed.

13. Changes in board of directors, section 16 of the present bill: The provisions of section 16 are satisfactory except in respect to a special situation which now exists.

The bill should not interfere in this respect with the operation of existing strict trusts except to provide for the right of removal of trustees by the holders of two-thirds of outstanding certificates. The concept of a trusteeship is different from the corporate idea. It seems reasonable to permit their continued existence.

14. Transactions of certain affiliated persons and underwriters, section 17 of the present bill: The prohibition on self-dealing is approved and there should be prohibited any sales to or purchases from

insiders whether of portfolio securities or other property and also any loans to insiders. Agency fees and similar payments should be exempt and it seems reasonable to give to the Commission power to grant by general rules and regulations exemptions under certain circumstances to these flat prohibitions.

This section also deals with custodianship of the securities of investment companies. It is suggested that provision be made that all such securities be placed with (1) a bank or trust company subject to Federal or State supervision; (2) a private banking organization if subject to State or Federal supervision; or (3) institutions subject to control and discipline of a national securities exchange under the Securities and Exchange Act of 1934.

The obscure and indefinable provision in section 17 regarding gross misconduct and gross abuse of trust should be eliminated. Also, the provision requiring change of charters, bylaws, trust indentures, etc., should be deleted as unnecessary.

15. Capital structure, section 18 of the present bill: In lieu of the prohibition on the future issue of senior securities, provision should be made for the limitation on the future issue of senior securities of closed-end companies in some such manner as the following: In the case of debentures, there should be a minimum coverage of assets at the time of issuance of 300 percent, and in the case of preferred stock, a minimum coverage of 200 percent, including any obligations senior to the preferred stock. Dividend restrictions to correspond should be provided as to future issues of preferred stock. All stock, whether preferred or common, should have voting privileges. The exception with respect to existing strict trusts heretofore discussed in paragraph 13 would apply to this situation.

Refunding of existing senior securities should, of course, be permitted.

The subsection dealing with redistribution of existing voting rights should be eliminated.

16. Dividends, section 19 of the present bill: Provision should be made for full disclosure to shareholders as to the source of any dividend. Requirements as to dividends in relation to senior securities hereafter issued have been discussed in No. 15.

The provisions of the proposed bill which interfere drastically with existing contract rights are indefensible.

17. Proxies: Voting trusts: Circular ownership, section 20 of the present bill: The proxy requirements of the Securities and Exchange Act of 1934 which now apply to such investment companies as are listed on any national security exchange should be made to apply to all investment companies.

The prohibition of voting trusts is approved except that voting trusts presently existing under State laws should be permitted to be continued.

The complicated provisions in respect to circular ownership are replaced by the limitation on investment of one investment company in the stock of another provided for in No. 10.

18. Loans, section 21 of the present bill: Borrowings should be prohibited only to the extent of the limitation on indebtedness provided in No. 15 dealing with future capital structure, and provision should also be made permitting the refunding of any existing indebt-

edness and permitting borrowings for temporary purposes. Needless to say, loans to insiders are prohibited as self-dealing in paragraph No. 14.

19. Distribution, redemption, and repurchase of redeemable securities, section 22 of the present bill: These sections have to do primarily with problems of dilution and excessive sales loads. As these are problems affecting distributions and transactions with dealers, all of whom are members of a securities association organized and regulated under the Maloney Act, this section should provide that the rules of such securities association may deal with this subject matter. This section should also provide that no securities issued by an investment company shall be sold to insiders or to anyone other than an underwriter or dealer except on the same terms as are offered to other investors. Appropriate provision may be made for mergers.

This section should also provide that the redemption privileges of any redeemable security shall not be suspended except (*a*) for a period of not more than 7 days, or (*b*) in case of an emergency, including a period during which the New York Stock Exchange is closed, or (*c*) under such other circumstances as the Commission may by rules and regulations or by orders permit.

20. Repurchase of securities: Closed-end management companies, section 23 of the present bill: The purchase by closed-end investment companies of outstanding securities should be permitted only on the open market or pursuant to tenders or under such other circumstances as the Commission may prescribe by rules and regulations or orders.

21. Periodic reports, accounts and accountants, sections 30, 31, and 32 of the present bill: Investment companies should be required to send to their shareholders periodic reports. Bearing in mind the expense in relation to smaller companies, the requirement should probably not be for more than semiannual reports. These reports should be certified to at least annually by independent public accountants. Each report should include:

(*a*) Balance sheet showing the market or appraised value of securities and a list of securities held.

(*b*) When certified by public accountant, the certificate should include a verification of securities held or confirmation thereof from the custodian.

(*c*) The income account should show the source of all substantial items of income.

(*d*) Expenses should be broken down in detail at least as to those items constituting 10 percent or more of the total expenses.

(*e*) The report should include a supplemental statement of amounts paid to any director or interested person in the way of stock-exchange commissions, legal fees, or agency or similar payments.

The Commission should be directed to consult with representatives of the industry and public accountants, with a view to encouraging a reasonable degree of uniformity in accounting standards. We approve the theory of a periodic verification of security holdings and transactions outlined by Mr. Bailie and referred to at these hearings. But this is quite different from giving the S. E. C. a roving commission with inquisitorial powers, as provided for in the present bill.

22. Destruction and falsification of reports and records, section 34 of the present bill: This section dealing with destruction and falsifi-

cation of reports and records should be confined to corporate documents and corporate accounts.

23. Unlawful representations and names, section 35 of the present bill: The prohibition in the present bill in respect to unlawful representations is satisfactory and the adoption of misleading names should be prohibited. There is no necessity for any discretion to the Commission.

24. Rules, regulations, and orders—General powers of Commission, section 36 of the present bill: The general authority contained in subparagraph (a) of section 36 of the present bill should be made to apply only to specific sections of the bill which may require rules and regulations and should also be more limited in the scope of the power granted to the Commission.

25. Hearings by Commission, section 37 of the present bill: A policy should be expressed for consultation by the Commission with representatives of the industry, and for public hearings in the discretion of the Commission whenever it appears that there is a substantial demand for such hearings. Neither should be mandatory.

Provision should be made for hearings in respect of any formal proceeding before the Commission in relation to any proposed order.

26. Court review of orders—Jurisdiction of offenses and suits, sections 39 and 40 of the present bill: The provisions of sections 39 and 40 in the present bill are satisfactory.

27. Information filed with the Commission, section 41 of the present bill: This section is satisfactory as applied to the bill herein proposed. The effect of these provisions, however, if applied to the bill as introduced are much too far-reaching.

28. Annual reports of Commission, etc., section 42 of the present bill: This is satisfactory.

29. Penalties, section 43 of the present bill: There can be no question that penalties must be provided for violation of the act. The extent of the penalties is a matter in respect of which we would prefer to make no suggestions to the committee.

30. Effect of existing law, section 44 of the present bill: This section as it now stands is satisfactory.

31. General definitions, section 45 of the present bill: Many of these definitions need revision, but this is a matter for detailed drafting.

32. Separability of provisions, section 46 of the present bill: This is satisfactory.

Unit investment trusts, periodic payment plans, face amount certificate companies, sections 26, 27, 28, and 29 of the present bill: As the characteristics of these companies are essentially different from those of the ordinary investment company, it seems desirable that these subjects be dealt with under a separate title of the bill.

Sections which have been eliminated: There have been eliminated from this framework sections 11, 14, 24, 25, 33, and 38. These have to do with the recurrent promotion of investment companies, limitation on size, additional requirements in respect to prospectuses and sales literature, absolute jurisdiction to the Commission over voluntary reorganizations and recapitalizations, settlement of civil actions, and broad powers of investigation to the Commission. All of these subjects have been dealt with in the hearings before you. I might

just add the following brief comments as to a few of the sections eliminated.

Section 24 dealt with registration and sales literature in connection with the selling of securities. It is believed by us that this is properly taken care of by the Securities Act of 1933. If any additional provisions are needed, it should be by amendment to that act.

As has already been pointed out, Section 25 dealing with reorganizations and recapitalizations is one of the most drastic provisions of the bill. So far as insolvent companies are affected, this is covered by the Bankruptcy Act. Proxy regulations give the Commission power to require full disclosure to stockholders. This would seem to be adequate and there seems to be no reason why investment companies should be treated differently from any other type of company in respect to this matter.

Similarly in respect to section 33 dealing with the settlement of civil actions, there is no reason why investment companies should be treated in any manner different from other companies. The implications of these provisions are much too far reaching to be accepted without a most thorough study of the subject matter.

That, gentlemen, completes our comments.

I also, as Judge Healy has done, would like to thank this committee very earnestly for their sincere attention to and interest in the material which we had to present on the part of the industry.

Senator HUGHES (presiding). Thank you, Mr. Bunker. I am sure that your statement will be very valuable to the committee.

Mr. BUNKER. I also want to thank Judge Healy for his consideration in all these matters and for his courtesy and kindness to the members of the industry.

Senator HUGHES (presiding). The hearings are closed. If there is a further meeting the chairman will call it.

(Whereupon, at 4:15 p. m., the hearings were closed.)

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